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No. _____

In The

Supreme Court of the United States

October Term, 1994

VICTOR WEXLER,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Third Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether a court of appeals has the power, on petition by the Government in a criminal case, to issue the extraordinary writ of mandamus to compel a district judge to modify a proposed preliminary jury instruction, where (a) the instruction allegedly constitutes a "clear error of law," and (b) if given, would create a "high probability of failure" of the prosecution, but where (c) there is no allegation that the district judge abused his discretion or exceeded his jurisdiction.

2. Whether a court of appeals has the power to issue the extraordinary writ of mandamus to correct a "clear error of law" in a proposed preliminary jury instruction where the Criminal Appeals Act bars the Government's right to appeal the district judge's instruction.

PARTIES

In the mandamus proceeding before the Third Circuit, the United States was the petitioner and Victor Wexler was the respondent.

The Honorable John W. Bissell, Judge of the United States District Court for the District of New Jersey, was named as a nominal respondent in the Third Circuit proceeding, but made no appearance and filed no brief therein. Judge Bissell is not named as a party to the certiorari proceeding now before this Court.

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PETITION FOR WRIT OF CERTIORARI

The petitioner Victor Wexler respectfully prays that a writ of certiorari issue to review the opinion and judgment of the United States Court of Appeals for the Third Circuit entered in this mandamus proceeding on July 14, 1994.

OPINIONS BELOW

The opinion of the Third Circuit, granting a writ of mandamus, was entered on July 14, 1994. It has been

reported at 31 F.3d 117 (3d Cir. 1994). It is reprinted in the appendix. (App. 1)

Judge Bissell of the United States District Court for the District of New Jersey entered the proposed jury instruction, with an accompanying opinion, on November 1, 1993. Neither the order nor the opinion is reported, but both are reprinted in the appendix (App. 34) along with the District Court's November 5, 1993 order denying reconsideration (App. 52) and November 30, 1993 order of clarification. (App. 54)

JURISDICTION

The writ of mandamus and the opinion of the Third Circuit were entered on July 14, 1994. A petition for rehearing and a suggestion for rehearing *in banc*, filed by petitioner Wexler, were both denied on August 12, 1994. (App. 60) This petition for certiorari has been filed within 90 days of the denial of the rehearing petition.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

28 U.S.C. § 1651. Writs

(a) The Supreme Court and all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law.

18 U.S.C. § 3731. Appeal by United States

In a criminal case an appeal by the United States shall lie to a court of appeals from a decision, judgment, or order of a district court dismissing an indictment or information or granting a new trial after verdict or judgment, as to any one or more counts, except that no appeal shall lie where the double jeopardy clause of the United States Constitution prohibits further prosecution.

An appeal by the United States shall lie to a court of appeals from a decision or order of a district courts [*sic*] suppressing or excluding evidence or requiring the return of seized property in a criminal proceeding, not made after the defendant has been put in jeopardy and before the verdict or finding on an indictment or information . . . .

An appeal by the United States shall lie to a court of appeals from a decision or order, entered by a district court of the United States, granting the release of a person charged with or convicted of an offense, or denying a motion for revocation of, or modification of the conditions of, a decision or order granting release.

The appeal in all such cases shall be taken within thirty days after the decision, judgment or order has been rendered and shall be diligently prosecuted.

The provisions of this section shall be liberally construed to effectuate its purposes.

STATEMENT OF THE CASE

The relevant facts in this case are largely procedural. The sole question is whether the Third Circuit has power, under the All Writs Act, to issue a writ of mandamus compelling District Judge Bissell to vacate a proposed preliminary jury instruction on a substantive legal proposition, crafted at the pre-trial stage of a criminal proceeding, and to substitute an instruction suggested by the Government.

(a) The interest-deduction controversy

The indictment alleges that from 1980 to 1985, petitioner Victor Wexler served first as financial officer and then as managing partner of McMahan, Brafman, Morgan & Co. ("MBM"), a limited partnership engaged in securities trading. Following a prolonged investigation, Wexler was indicted in 1992 (followed by a superseding indictment in 1993) for having filed, and aiding and abetting in the filing of, false federal income tax returns, both for himself and limited partners of MBM, during the 1982-1986 period.

More specifically, the eight-count indictment charged Wexler with:

(1) Conspiring to defraud the United States by obstructing the lawful governmental functions of the Internal Revenue Service. 18 U.S.C. § 371.[1]

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[1] Section 371 makes criminal a conspiracy between or among two or more persons "to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose. . . . "

(2) Aiding and abetting in the preparation of false individual and partnership tax returns. 26 U.S.C. § 7206(2).[2] The superseding indictment charged that petitioner Wexler had created over $160,000,000 in "bogus" tax deductions for the MBM partnership during the 1982-1986 period. These deductions were alleged to be the product of non-deductible interest expenses arising out of repurchase agreements that are commonly employed by firms to finance the purchase of government securities.[3]

As District Judge Bissell explained, Wexler allegedly created these fraudulent tax deductions for his MBM partners "by causing MBM to participate in securities transactions which generated large, ostensibly deductible interest expenses on paper, but which were in fact secretly prearranged to ensure that MBM would neither earn profit nor bear risk of incurring actual expenses or

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[2] Section 7206(2) provides that any person who "[w]illfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document . . . shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution."

[3] An explanation of the complex nature of repurchase agreements transactions is set forth in the Third Circuit's opinion below. (App. 4-8)

trading losses. The government alleges that these transactions created deductions which led to fraudulent tax savings in the hundreds of millions of dollars." (App. 35)

The Government contends that the transactions, while real, were motivated solely by tax considerations and were therefore economic shams. Moreover, paragraphs 12 and 13 of Count 1 of the indictment charged:

> 12. At the same time, WEXLER and his co-conspirators fraudulently rigged and pre-arranged the above trades to ensure that MBM and its partners *would not be exposed to any risk of incurring actual interest expenses* or trading losses which they would be required to pay out of pocket. [Emphasis added.]
>
> 13. . . . Those oral agreements provided that MBM would neither earn any profits nor sustain any losses on the transactions, except that MBM would *pay the colluding entities fixed fees disguised as trading profits or interest income to those entities.* [Emphasis added.]

(Gov't Pet. for Mandamus at A008-A009) Significantly, these charges obliged the Government to prove that there was no "genuine indebtedness" arising out of the transactions in question.

In September, 1993, one month before the scheduled trial, the Government informed the District Court that the parties had a fundamental disagreement as to the law relating to the governmental securities trades at issue. The Government then informally submitted a proposed jury charge, entitled "Government's Proposed Jury Charge – Lack of Economic Substance." (App. 9) The request was that this charge be used as a preliminary jury

instruction before openings and before any testimony was presented. The Government proposed the following instruction:

> I instruct you that, if [the government securities transactions in this case] were sham transactions, then interest and other expenses that MBM incurred as a result of the transactions were not deductible. Whether or not the transactions were shams is a question that is for you to decide. I instruct you, however, that you must find the transactions were sham transactions if you determine two things beyond a reasonable doubt:
>
> *First*, that MBM had no business purpose for entering into the transactions other than to obtain tax benefits; and
>
> *Second*, that there was no reasonable possibility that MBM could earn a profit on the transactions apart from tax benefits.

(App. 9)

Shortly thereafter, petitioner Wexler countered with a proposed instruction reading in pertinent part as follows:

> Assuming the Government has proven that the governmental security trades were sham transactions (i.e. no business purpose *and* devoid of economic substance), you cannot convict the defendant if you find that the interest expenses at issue were the product of a "genuine indebtedness". In other words, regardless of any conclusions you reach as to the motivation of the defendant or the lack of economic substance, the existence of a genuine debt between MBM and its trading partners, will permit the deduction of

> interest. Under the tax laws, even a sham transaction may have elements that have economic substance, and these elements of the transaction must be respected for tax purposes. Accordingly, if you find that the financing agreement to purchase the government securities is genuine and enforceable, the interest may be deducted.

(App. 9-10)

Thus the battle line between the two parties was drawn. The Government's position was that interest could not be deducted if the transaction was found to be an economic sham, i.e., lacking any legitimate business purpose and motivated solely by tax consequences. The petitioner's position was that interest could be deducted, even though the trades were found to be "economic shams" as defined in the Government's instruction, so long as the interest expenses grew out of a genuine debt between MBM and its trading partners.

(b) The District Court's instruction

On November 1, 1993, District Judge Bissell adopted an instruction on sham transactions to be delivered to the jury. He borrowed central portions of both parties' proposals. Thus he adopted the Government's two-pronged definition of a "sham transaction." But while he instructed that interest incurred on sham transactions was not deductible, he further instructed that there was an exception to that rule where interest expenses stemming from a sham transaction were in fact incurred as a result of a "genuine indebtedness" – just as the petitioner had requested. In the critical portion of his instruction, Judge Bissell wrote:

> Assuming the government has proven that the government security trades were sham transactions (i.e. no business purpose *and* devoid of economic substance), you may convict the defendant on the count you are considering only if you find that the interest expenses at issue were not the product of a "genuine indebtedness." In other words, regardless of any conclusions you reach as to the motivation of the defendant or the lack of economic substance in any transaction as a whole, the existence of a genuine debt between MBM and a trading partner, could permit the deduction of interest under the Internal Revenue Code. Under the tax laws, even an economic sham transaction may have some items or events that have economic substance, and those parts of the transaction could generate lawful interest deductions.

(App. 48-49)

Judge Bissell accompanied his instruction with a 13-page opinion detailing the legal basis for the instruction. (App. 34) He wrote that while transactions that are shams generally do not yield legitimate deductions, he rejected the Government's argument that an economic sham can never be the basis for a legal deduction. Rather, he agreed with petitioner's contention that portions of an economic sham that result in "genuine indebtedness" may be deductible. In doing so, the petitioner contends that he merely followed the law established in four other circuits and the Tax Court.

In support of that proposition, Judge Bissell relied upon a Fourth Circuit decision in *Rice's Toyota World, Inc. v. C.I.R.*, 752 F.2d 89 (4th Cir. 1985). There the Fourth

Circuit, in turn relying on Tax Court precedents, recognized "that a sham transaction may contain elements whose form reflects economic substance and whose normal tax consequences may not therefore be disregarded." *Id.* at 96. Judge Bissell also found that several other courts, including the Second Circuit and the Tax Court, have cited with approval *Rice's Toyota* for the proposition that an economic sham can still yield valid interest deductions if a debt underlying the transaction is a genuine debt.

Because of the impressive supporting case law, Judge Bissell rejected the Government's contention that *Rice's Toyota* should be rejected because "it is wrongly-decided and poorly reasoned." (App. 45)

(c) The Third Circuit mandamus proceeding

On November 2, 1993, the day following the issuance of Judge Bissell's instruction and explanatory opinion, the Government advised the court that it would be unwilling to continue prosecuting Wexler in light of the court's ruling on the previous day. The ruling was said to have altered the theory of the prosecution. The Government asked that the court restyle its ruling as an order dismissing the indictment for failure to state an offense, asserting that without such an order, any appeal by the Government would be barred by the Criminal Appeals Act, 18 U.S.C. § 3731.

But, in light of the fact that the indictment contained allegations that the debt was not genuine, Judge Bissell declined the invitation to render an "arbitrary and capricious" dismissal order simply to generate an appealable

issue. In so doing, the court rejected the notion that its ruling had altered the theory of the prosecution. The indictment charged that the interest paid in the course of the allegedly sham transactions was not genuine or "actual interest." The court's instruction was consistent with these allegations, dealing as it did with the legal deductibility of interest generated by a genuine debt.

The Government sought unsuccessfully several "clarifications" of Judge Bissell's jury charge, although the judge did make some minor language modifications in the charge. The Government also sought and obtained several adjournments of the trial date in order that the U.S. Attorney might consult with the Department of Justice for authority to file a mandamus petition. Finally, on December 2, 1993, the Government filed its petition for mandamus in the Third Circuit and obtained a stay of the trial (which has yet to take place).

The Government's petition, while acknowledging that mandamus is proper only in extraordinary situations, asserted that "the unusual facts of this case satisfy this high [mandamus] standard." (Gov't Pet. for Mandamus at 22) The "unusual facts" were said to take the form of Judge Bissell's "clear legal error" in crafting the jury instruction respecting the deduction of interest expenses generated by economic sham transactions. In the petition's words,

> The district court has ruled contrary to well-established precedent that the Internal Revenue Code allows taxpayers to deduct interest expense generated by economic sham transactions. That ruling constitutes clear legal error.

> Further, the United States will have no opportunity to appeal the error. Under the district court's ruling, the United States will be unable in good faith to proceed to trial, and will effectively be forced to dismiss the superseding indictment below.
>
> Thus, the district court's erroneous ruling threatens to terminate a meritorious prosecution – a grave injustice to the government. Where a clearly erroneous, but unappealable, district court order creates such detrimental consequences, we submit, mandamus is available to correct the error of the district court.

(*Id.* at 22-23)

On July 14, 1994, the Third Circuit panel granted the Government's petition for writ of mandamus, directed the District Court to vacate its jury-instruction order of November 30, 1993, and ordered that "the proceedings in the underlying case shall be consistent with this opinion." (App. 31) The panel opinion was written by District Judge Pollak and joined by Circuit Judge Roth. Circuit Judge Greenberg concurred separately "with some reluctance." (App. 31)

The Third Circuit panel ruled as follows:

(1) The general rule on sham transactions "in this circuit is well-established: 'If a transaction is devoid of economic substance . . . it simply is not recognized for federal taxation purposes, for better or for worse. . . . ' *Lerman v. Comm'r of Internal Revenue*, 939 F.2d 44 (3d Cir. 1991), *cert. denied*, 112 S.Ct. 1940 (1992)." (App. 13)

(2) The court rejected Wexler's claim that, under 26 U.S.C. § 163(a), deductions are permitted for interest

obligations resulting from sham transactions as long as those obligations are "genuine" – i.e., binding and enforceable.[4] The court cited *Knetsch v. United States*, 364 U.S. 361 (1960), in rejecting this argument. (App. 15-16)

(3) The court also rejected Wexler's argument that recent decisions of the Fourth and Second Circuits and of the Tax Court reflect "a modern trend towards a genuine indebtedness exception for § 163 deductions – an exception that the district court was correct to follow." (App. 20) The Fourth Circuit decision, of course, was *Rice's Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985), the principal case relied upon by Judge Bissell in formulating the jury instruction at issue.

The Third Circuit proceeded to analyze and distinguish *Rice's Toyota*, the Second Circuit ruling in *Jacobson v. Commissioner*, 915 F.2d 832 (2d Cir. 1990), and the Tax Court decision in *Lieber v. Commissioner*, 66 T.C.M. (CCH) 722 (1993). Indeed, it took the Third Circuit more than three pages of analysis of *Rice's Toyota* before arriving at a rejection of that case "as authority for the instruction adopted by the district court. . . . " (App. 21) And the court took more than seven pages to analyze and distinguish all three of these authorities that Wexler advanced in support of Judge Bissell's instruction. (App. 20-27)

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[4] Section 163(a) provides that "[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." Wexler argued that, in contrast to other sections of the Code dealing with deductions, Section 163(a) does not require any profit motive, or the conduct of a trade or business, to claim interest deductions.

Only after this extended discussion was the Third Circuit able to say that Judge Bissell's instruction "would render the sham transaction doctrine inert, and that the instruction is at odds with the overwhelming weight of the relevant case law." (App. 27)

(4) The Third Circuit then concluded that, "on the basis of the foregoing discussion, we find that the 'genuine indebtedness' instruction adopted by the district court constitutes clear error under established law . . . [and that the instruction] conflicts with the established law of this circuit, and with the dominant line of precedent following the Supreme Court's ruling in *Knetsch* and the Second Circuit's ruling in *Goldstein*." (App. 27-28)

(5) The court next turned to the propriety of issuing a writ of mandamus. Relying mainly upon Third Circuit precedent, the court declared that the mandamus petitioner must first prove that the district court committed either a "clear abuse of discretion" or a "clear error of law," and that the Government had met that burden in this case. (App. 28)

Again relying on Third Circuit precedent, the court found that two other mandamus requirements had been met: First, the Government had shown that it has no alternative avenue of relief, since no appeal would be possible once trial begins, for double-jeopardy reasons. Second, the Government had shown irreparable injury in that if "jury deliberations guided by the erroneous instruction end in an acquittal, the injury to the government will be irremediable. [Footnote omitted.]" (App. 28)

In footnote 16 of the panel opinion, the court dismissed Wexler's argument that issuance of the writ in

this case would contravene the Criminal Appeals Act, 18 U.S.C. § 3731, and would be contrary to the mandamus principles enunciated by this Court in *Will v. United States*, 389 U.S. 90 (1967). (App. 29-30)

(6) The court concluded by finding "that the adoption of a clearly erroneous jury instruction that entails a high probability of failure of a prosecution – a failure the government could not then seek to remedy by appeal or otherwise – constitutes the kind of extraordinary situation in which we are empowered to issue a writ of mandamus." (App. 30-31)

Circuit Judge Greenberg's concurrence expressed "some reluctance" about the Government's argument that Judge Bissell's instruction was based upon a fundamentally incorrect reading of the tax law, which would force the Government to dismiss the charges against Wexler. What bothered Judge Greenberg was that the Government

> is challenging a conclusion reached by the district court in a carefully crafted formal, though unpublished opinion, rendered after the court considered the appropriate authorities, including some of the very cases we cite, *e.g.*, *Lerman v. Comm'r*, 939 F.2d 44 (3d Cir. 1991), *cert. denied*, 112 S.Ct. 1940 (1992). Furthermore, the district court adhered to its conclusion on reconsideration. Therefore, Wexler is being prosecuted in a case in which the government intends to demonstrate that he acted in what the district court believed was a lawful manner. This circumstance almost has caused me to vote to deny the government's petition.

(App. 32) Under these circumstances, Judge Greenberg added, he had difficulty reconciling Wexler's prosecution with the principles underlying *Cheek v. United States*, 498 U.S. 192 (1991), a decision that "throws into question the fairness of Wexler's prosecution for even the district court did not believe that Wexler violated 'the duty at issue.' "(App. 32)

Finally, on August 12, 1994, the Third Circuit denied without comment Wexler's petition for rehearing and his suggestion for rehearing *in banc*. (App. 60) In that petition, Wexler reiterated that the decision in this case is in direct conflict with the Second Circuit decision in *United States v. Margiotta*, 662 F.2d 131 (2d Cir. 1981), *cert. denied*, 461 U.S. 913 (1983). The Second Circuit there held that granting mandamus to review the merits of the Government's contentions regarding a pretrial jury instruction would contravene the limitations of the Criminal Appeals Act.

REASONS FOR GRANTING THE WRIT

The Third Circuit has extended the use of the extraordinary writ of mandamus beyond the boundaries established by this Court. Such an important development in the administration of the federal criminal justice system ought not to go unreviewed by this Court.

I. THE THIRD CIRCUIT'S GRANT OF MANDAMUS TO REVIEW A "CLEAR LEGAL ERROR" IN A PROPOSED PRELIMINARY JURY INSTRUCTION IS AT ODDS WITH CONTROLLING PRECEDENTS.

The critical holding of the Third Circuit is its finding "that the adoption of a clearly erroneous jury instruction

that entails a high probability of failure of a prosecution – a failure the government could not then seek to remedy by appeal or otherwise – constitutes the kind of extraordinary situation in which we are empowered to issue the writ of mandamus." (App. 30-31)

That holding is unprecedented. It flies in the face of the mandamus principles established by this Court, particularly as expressed in *Will v. United States*, 389 U.S. 90 (1967). And by elevating a "clearly erroneous" preliminary jury instruction to the level of an "extraordinary situation" justifying mandamus review, the Third Circuit creates important and confusing problems in the administration of federal criminal law. Consider the following:

First. We start with the basic proposition that "appeals by the Government in criminal cases are something unusual, exceptional, not favored." *Carroll v. United States*, 354 U.S. 394, 400 (1957). Appeals by way of mandamus are no exception to that rule.[5] As this Court said in *Will v. United States*, "only exceptional circumstances amounting to a judicial 'usurpation of power' will justify the invocation of this extraordinary [mandamus] power." 389 U.S. at 95. And, if the order in question be within the district court's discretion, the Government must demonstrate a "clear abuse of discretion." *See Mallard v. United States District Court*, 490 U.S. 296 (1989).

The Third Circuit held, not that Judge Bissell committed a "clear abuse of discretion" in framing the pre-trial

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[5] For the most part, appeals by the Government in criminal cases are limited to those categories specified in the Criminal Appeals Act, 18 U.S.C. § 3731. *See* further discussion of this matter at pages 22-27 of this petition, *infra*.

jury instruction, but that he committed a "clear error of law" in so doing. In other words, while conceding that the district judge had jurisdiction to enter the order, the Government sought mandamus to correct the text of the order. To support that "clear error of law" proposition, only a Third Circuit decision is cited, *In re Bankers Trust Co.*, 775 F.2d 545, 547 (3d Cir. 1985) ("before the writ may issue, we must find a clear legal error calling for relief"). Significantly, the Third Circuit cites no decision of this Court holding that a "clear error of law" justifies issuance of mandamus. There is no such decision.

Throughout its opinion, the Third Circuit has utilized its own precedents to perpetuate a radical departure from established mandamus standards, a departure that two (and arguably three) other Circuits have also followed.[6]

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[6] Among other Third Circuit precedents recognizing "clear legal error" as a basis for issuing mandamus are: *Cipollone v. Liggett Group, Inc.*, 785 F.2d 1108 (3d Cir. 1986), *cert. denied*, 484 U.S. 976 (1986); *Sporck v. Peil*, 759 F.2d 312 (3d Cir.), *cert. denied*, 474 U.S. 903 (1985); *Carteret Savings Bank v. Shushan*, 919 F.2d 225 (3d Cir. 1990), *cert. denied*, 113 S.Ct. 61 (1992) ("clear error of law" in ordering a case transferred); *Communication Workers v. American Tel. & Tel.*, 932 F.2d 199 (3d Cir. 1991); *Lusardi v. Lechner*, 855 F.2d 1062 (3d Cir. 1988) ("clear error of law" that "at least approach[es] the magnitude of an unauthorized exercise of judicial power").

The Ninth Circuit, in establishing its own five-point guidelines for issuing writs of mandamus, includes as one guideline the following: "The district court's order is clearly erroneous as a matter of law." *See, e.g., United States v. Barker*, 1 F.3d 957, 959 (9th Cir. 1993), *modified*, 20 F.3d 365 (1994); *Bauman v. U.S. District Court*, 557 F.2d 650, 654-55 (9th Cir. 1977).

The Sixth Circuit has approved and followed the Ninth Circuit's five guidelines, including the "clearly erroneous" standard. *In re Gillis*, 836 F.2d 1001, 1012 (6th Cir. 1988); *In re Bendectin Products Liability Litigation*, 749 F.2d 300, 304 (6th Cir. 1984).

Analysis of those Third Circuit precedents shows that this "clear error of law" concept is mistakenly traced to this Court's rulings that a mandamus petitioner must show that the right to issuance of the writ is "clear and indisputable." *Will v. United States*, 389 U.S. at 96; *Bankers Life & Cas. Co. v. Holland*, 346 U.S. 379 (1953); *United States v. Duell*, 172 U.S. 576 (1899).

In other words, the Third Circuit has mistaken a "clear error" for a "clear and indisputable right to issuance." That is like mistaking oranges for apples. "Clear legal error" is nothing more extraordinary than reversible legal error, the hallmark of the ordinary appeal process. But mandamus "may never be employed as a substitute for appeal," *Will*, 389 U.S. at 97, even though clear errors of law may be involved. And a clear "right to issuance" means only that the mandamus petitioner, having satisfied all the established requirements, is "clearly entitled to issuance of the writ." It follows that such a radical departure from established mandamus standards deserves plenary review and correction by this Court.

Second. Even on the Third Circuit's mistaken "clear error of law" premise, it is unlikely that Judge Bissell's proposed jury instruction can be classified as so clearly

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The Tenth Circuit, while purporting to approve the Ninth Circuit's guidelines, observed that the "clearly erroneous" concept has been used by many courts, including the Ninth Circuit, interchangeably with "abuse of discretion." Thus "to avoid any confusion, we have phrased this third guideline in terms of abuse of discretion." *In re Dalton*, 733 F.2d 710, 717 (10th Cir. 1984), *cert. dismissed*, 469 U.S. 1185 (1985).

erroneous as to justify an extraordinary mandamus review and reversal.

As Circuit Judge Greenberg said below, Judge Bissell's instruction was based on "a carefully crafted formal, though unpublished opinion, rendered after the court considered the appropriate authorities, including some of the very cases we cite. . . . " (App. 32) And before concluding that Judge Bissell's analysis of a very complex and obscure provision of tax law was incorrect and inconsistent with the law of the Circuit, the Third Circuit had to devote seven pages of its opinion to analyzing the tax problem, distinguishing allegedly conflicting authorities and creating a novel and important tax-deduction precedent.

But nowhere is there any finding that Judge Bissell's ruling is so outrageous, so frivolous, so manifestly wrong, as to constitute a usurpation of power or to go beyond the accepted and usual course of judicial proceedings. That ruling was a studied response to "a question of law decisive of the issue presented" by the Government's proffered instruction; and the ruling "was made in the course of the exercise of the court's jurisdiction to decide issues properly brought before it." *Bankers Life & Cas. Co. v. Holland*, 346 U.S. at 382.

Even if erroneous or reversible error, even if contrary to the law of the Third Circuit, Judge Bissell's ruling "involved no abuse of judicial power." *Id.* Nor is there any claim that Judge Bissell somehow abused his discretion in resolving this legal proposition. To issue mandamus in such a situation is to create a most dangerous

precedent, contrary to all of this Court's mandamus jurisprudence. As the Third Circuit's Judge Hastie once observed, a challenged action of a district judge

> must be so plainly wrong as to indicate failure to comprehend or refusal to be guided by unambiguous provisions of a statute or settled common law doctrine. If a rational and substantial legal argument can be made in support of the questioned jurisdictional ruling, the case is not appropriate for mandamus or prohibition even though on normal appeal a reviewing court might find reversible error.

American Airlines, Inc. v. Forman, 204 F.2d 230, 232 (3d Cir. 1953).

Nor, said this Court in *Will*, should a court "be misled by labels such as 'abuse of discretion' and 'want of power' into interlocutory review of nonappealable orders on the mere ground that they might be erroneous." 389 U.S. at 98, n. 6.

Third. The main prop for the Third Circuit's use of mandamus to review a "clearly erroneous jury instruction" was the thought that such an instruction "entails a high probability of failure of a prosecution – a failure the government could not then seek to remedy by appeal or otherwise. . . . " (App. 30-31) But this Court's decision in *Will* undermines this basis for issuing mandamus. The Court there wrote:

> Congress clearly contemplated when it placed drastic limits upon the Government's right of review in criminal cases that it would be completely unable to secure review of some orders

> having a substantial effect on its ability to secure criminal convictions.

389 U.S. at 97, n. 5. That is true even though the challenged order "forces dismissal of [the Government's] case." *DiBella v. United States*, 369 U.S. 121 (1962).

Fourth. The final prop in support of the Third Circuit's issuance of the writ is the unexplored assumption that the Government could not seek to remedy the pretrial jury instruction "by appeal or otherwise." Granted, that instruction was not an appealable final order or a dismissal of the indictment. But the instruction was given before the start of the trial. It has been variously described by the Third Circuit as "preliminary," "proposed," and "intended" in nature. If that be true, then Judge Bissell will have to renew or revise the instruction at the end of the trial in light of the evidence produced and before the case goes to the jury. Rule 30 of the Federal Rules of Criminal Procedure would then give the Government the right to "file written requests that the court instruct the jury on the law as set forth in the requests."

Such are the problems arising from the Third Circuit's use of the "clear error of law" doctrine as a basis for mandamus. They deserve consideration by this Court.

II. THE THIRD CIRCUIT HAS CREATED CONFUSION AND CONFLICT RESPECTING THE RELATIONSHIP BETWEEN THE ALL WRITS ACT AND THE CRIMINAL APPEALS ACT.

Buried in footnote 16 of its opinion, the Third Circuit has ruled that the Government is entitled to a mandamus review of a preliminary jury instruction in a criminal case

despite the fact that such an interlocutory order is preemptively made non-reviewable by the Criminal Appeals Act, 18 U.S.C. § 3731. That ruling is contradicted by this Court's analysis in *Will v. United States*, 389 U.S. 90 (1967), and is in direct conflict with the Second Circuit's decision in *United States v. Margiotta*, 662 F.2d 131 (2d Cir. 1981), *cert. denied*, 461 U.S. 913 (1983).

It is elementary that, when the Government seeks mandamus review of a decision, judgment, or order in a criminal case, the Government must have no alternative avenue of relief, such as an appeal. Since the Government cannot take an appeal "without express statutory authority [citation omitted]," *United States v. Wilson*, 420 U.S. 332, 336 (1975), the search for an alternative, at least in this case, begins and ends with the Criminal Appeals Act, 18 U.S.C. § 3731. That Act does not permit the Government to appeal the intended jury instruction here in issue, as the Third Circuit recognized. The instruction simply does not fall within any of the limited categories of orders that are appealable, it not being an order "dismissing an indictment" or "granting a new trial after verdict or judgment" or "suppressing or excluding evidence" or "granting the release of a person charged with or convicted of an offense."

But both the Third Circuit and the Government fail to appreciate that, as *Will* holds, the clear negative and non-appealability policies of the Criminal Appeals Act dictate that "appellate review should be postponed, except in [these] narrowly defined circumstances, until after final judgment has been rendered by the trial court." 389 U.S. at 96. That means that since the jury instruction in this case is not appealable under the Act, *Will* dictates that

mandamus "may never be employed as a substitute for appeal in derogation of these clear policies." *Id.* at 97.

The Third Circuit thus creates a significant problem in mandamus jurisprudence in holding that mandamus may be used to review the interlocutory jury instruction in this case "in derogation of these clear policies." In short, the Criminal Appeals Act would appear to preempt the Government's entitlement to mandamus review of "plain legal errors" in a proposed jury instruction. If the Act permits a Government appeal, mandamus becomes unnecessary. If the Act forbids a Government appeal, mandamus cannot then be employed in derogation of that negative policy. And if this Court failed to make that point clear enough in the *Will* case, now is the time to clarify the matter.

The Third Circuit's efforts to distinguish and undercut the implications of *Will* are unimpressive as well as reflective of the observation of two noted criminal law authorities: "the lower federal courts have found in that case [*Will*] quite different suggestions as to the appropriate use of the writs in criminal cases." 3 WAYNE R. LaFAVE & JEROLD H. ISRAEL, CRIMINAL PROCEDURE § 26.4, p. 23 (1984).

In footnote 16 of its opinion, the court seizes upon several open-ended statements in *Will*, such as (1) "This is not to say that mandamus may never be used to review procedural orders in criminal cases" (389 U.S. at 97), and (2) "We need not decide under what circumstances, if any, such a use of mandamus [to review an interlocutory procedural order in a criminal case that did not have the

effect of a dismissal] would be appropriate" (389 U.S. at 98). (App. 29-30)

Such statements merely reflect this Court's normal practice of limiting its opinion to the facts and circumstances of a given case, and not foreclosing further doctrinal developments based on different circumstances. And the circumstances in *Will* in no way involved a preliminary jury instruction; rather, they involved a pretrial order directing the Government to answer defendant's bill of particulars. It is difficult, if not impossible, to read these *Will* statements, as the Third Circuit reads them, to justify the court's conclusions that "*Will*, however, does not preclude the use of mandamus to review an interlocutory order that expresses an erroneous, preliminary jury instruction," or that "under *Will* the mandamus door is open far enough to include jury instructions." Even the Third Circuit, in footnote 16, has to admit that "it might be difficult to characterize a jury instruction as procedural" and thus within the scope of the *Will* quotations. (App. 29-30)

If *Will* has indeed opened the door to mandamus review of an interlocutory jury instruction that the Criminal Appeals Act makes non-reviewable, this Court should so declare. Is the alleged fact that the district judge, in framing the preliminary instruction, committed "clear error" with a "singular effect of crippling a prosecution,"[7] enough to create an exception to the Criminal Appeals Act? Is the extraordinary writ of mandamus to be

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[7] Reply Brief of Government, on Petition for Writ of Mandamus before the Third Circuit, at 11.

extended to a preliminary order that is neither procedural nor a dismissal? The confused and uncertain nature of the Third Circuit's opinion strongly suggests the need for clarification of the balance that Congress and this Court have struck between Government appeals under the Criminal Appeals Act and the Government's right to seek mandamus review under the All Writs Act.

The appropriateness of granting certiorari in this case is augmented by the existence of a direct conflict between the Third Circuit opinion and the Second Circuit's opinion in *United States v. Margiotta*, 662 F.2d 131 (2d Cir. 1981), *cert. denied*, 461 U.S. 913 (1983). In *Margiotta*, following a mistrial, the district judge indicated that he would abide by certain jury instructions at the forthcoming retrial. After finding that the instructions were not appealable under the Criminal Appeals Act, the Second Circuit addressed and dismissed the Government's petition for mandamus. Citing the *Will* case, the Second Circuit wrote:

> Mandamus is not to be employed to circumvent the limitations of the Criminal Appeals Act. [Citations omitted.] Granting mandamus to review the Government's contentions regarding the jury instructions would circumvent the limitations of the Criminal Appeals Act, which we find not to authorize an appeal to review the jury instructions.

662 F.2d at 134, n. 8. That ruling is at war with the result reached by the Third Circuit in the instant case.

In the proceedings below, the Government tried to distinguish *Margiotta* by referencing the Second Circuit's additional comment that the circumstances there did not

present a "compelling need" for mandamus in order to prevent "gross disruption in the administration of criminal justice." *Id.* at n. 8. Here, the Government says, Judge Bissell's proposed instruction must be reviewed to prevent "gross disruption in the administration of criminal justice," thus distinguishing *Margiotta*. But the instruction in *Margiotta* was no more disruptive than Judge Bissell's, both being within the sound discretion of the court. In any event, this argument merely underscores the appropriateness of granting certiorari to determine if "clear legal error" in framing a proposed jury instruction can – in the circumstances of this case – constitute a basis for mandamus review.

CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to review the decision of the Third Circuit in this proceeding.

Respectfully submitted,

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November 10, 1994

Filed July 14, 1994

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 93-5719

UNITED STATES OF AMERICA

Petitioner

v.

VICTOR WEXLER

Respondent

HONORABLE JOHN W. BISSELL
Nominal Respondent

On Petition for a Writ of Mandamus or
Prohibition to the United States District Court
for the District of New Jersey
(Related to D.C. No. 91-00181)

Argued February 4, 1994

BEFORE: GREENBERG AND ROTH, Circuit Judges and
POLLAK, District Judge*

(Filed: July 14, 1994)

Paul A. Welssman (Argued)
Edna B. Axelrod
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* Honorable Louis H. Pollak, Senior United States District Judge for the Estern District of Pennsylvania, sitting by designation.

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OPINION OF THE COURT

POLLAK, *District Judge.*

Before us is a petition from the United States for a writ of mandamus or prohibition directed to the Honorable John W. Bissell, United States District Judge for the District of New Jersey. The government's petition arises out of a pretrial order entered in a criminal tax fraud case against Victor Wexler which is to be tried before Judge Bissell. The order adopted a jury instruction on "genuine indebtedness" that, in the government's view, undermines a well-settled prohibition against deducting interest payments resulting from "sham transactions" – i.e. transactions entered into with no purpose other than to generate tax benefits. The government argues that the instruction adopted by the district court is clearly erroneous under settled law, and that the government will be unable to proceed with the present prosecution and will be severely prejudiced in other tax fraud prosecutions if the order remains in force. Wexler, responding to the petition[1], contends that the proposed instruction is a

[1] In formal terms, the judge of the district court is the person to whom the petition for mandamus is directed. But the defendant in the underlying criminal prosecution is of course

proper statement of the law and that, in any event, the extraordinary appellate intrusion on trial court proceedings sought by the government is unwarranted. We conclude that the petition should be granted.

Background

Between 1980 and 1985, the defendant in the underlying tax prosecution, Victor Wexler, served first as chief financial officer and subsequently as managing partner of McMahan, Brafman, Morgan & Co. ("MBM"), a limited partnership engaged in securities trading. Wexler was initially indicted on March 19, 1992. Subsequently a superseding indictment was filed. The superseding indictment consists of eight counts, and charges Wexler with, under *count 1*, conspiring (i) to defraud the United States by obstructing the lawful government functions of the I.R.S. in violation of 18 U.S.C. § 371, and (ii) to aid and assist in the preparation of false tax returns in violation of 26 U.S.C. § 7206(2); under *count 2*, aiding and assisting in the preparation of a U.S. Partnership Income Return, Form 1065, for MBM, for calendar year 1984, which falsely represented that MBM had incurred a loss of $75,491,898, in violation of 26 U.S.C. § 7206(2); under *count 8*, making and subscribing a joint individual income tax return. Form 1040, falsely representing that Wexler was entitled to a deduction of $103,928 flowing from his MBM partnership interest, in violation of 26 U.S.C. § 7206(1): under counts 3-7, aiding and assisting in the

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the real party in interest. Accordingly, the caption of this case characterizes Victor Wexler as "respondent" and Judge Bissell as "nominal respondent".

preparation by others of joint individual income tax returns, Form 1040, falsely representing that the taxpayers were entitled to deductions flowing from their MBM partnership interests, in violation of 26 U.S.C. § 7206(2). Superseding indictment, Appendix ("App.") at 5-21. The superseding indictment alleges that Wexler created over $160 million in fraudulent tax deductions for the MBM partnership from 1982 through 1986. According to the superseding indictment, the allegedly fraudulent deductions were the product of financial arrangements known as "repo to maturity" transactions.

"Repo" transactions: In order to be able to parse the charges against Wexler one needs to have a general understanding of what "repo" transactions are and how they work. In its brief in this court, as in its submissions to the district court, the government has described and provided examples of such transactions and their mechanics. Government Br. at 5-15. Since Wexler's brief does not quarrel with the government's exposition, we rely upon that exposition in this section of this opinion.

The word "repo" is an abbreviation for "repurchase agreement", the name given to a type of transaction commonly employed by firms dealing in government securities. The transaction – which may be consummated in a matter of days but may also span weeks or even a few months – is a sale of government securities, such as treasury notes, by one securities dealer to another, followed by their repurchase at a later date. But what is in form a sale and repurchase turns out in fact to constitute a loan for which the securities, during the interval between sale and repurchase, stand as collateral. An

example may serve to illustrate how such a transaction works:

Firm A sells Treasury notes with a face value of $1,000,000 to Firm B; the price paid by B to A – the "repo principal" – is a negotiated figure presumably geared to the market value of the notes at the date of sale; A concurrently contracts with B to buy the notes back at the same price at an agreed future date – e.g. thirty days or sixty days hence – which is earlier than the maturity date of the notes; on that future date B returns the securities to A, A repays the repo principal, and A also pays "repo interest", a sum negotiated along with the repo principal at the outset of the transaction, and presumably geared to the short-term interest rate then governing loans for the particular time-period – thirty days, or sixty days, or whatever – covered by the transaction.

The extent to which the "repo" turns out to be financially advantageous to A depends on what happens, during the course of the transaction, to (a) the market value of the securities, and (b) short-term interest rates. A hopes that, at the transaction's closing date, the reacquired securities will be worth more and short-term interest rates will be lower than when the transaction began. Under that fortunate combination of circumstances A would have the capability of entering into a second repo on substantially more favorable terms than the first.[2]

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[2] A might, of course, prefer to (a) sell the securities and harvest the gain, or (b) hold the securities with an eye to a further rise in market value.

The particular repo just described is one in which, as already noted, the transaction terminates on a date, agreed upon by the parties, which is earlier than the maturity date of the securities. That transaction is called an "open repo". If the repo's date of termination is the maturity date – the date on which the Treasury pays to the securities-holder the face value of the securities plus accrued coupon interest – the transaction is called a "repo-to-maturity". This litigation involves the tax consequences of repo-to-maturity transactions.

At its commencement a repo-to-maturity looks like an open repo, in the sense that A (a) transfers its Treasury securities to B in exchange for an agreed sum of repo principal and (b) promises that at the maturity date it will pay B an agreed amount of interest. But at that point the resemblance to an open repo ends. For, in a repo-to-maturity, A will not, at the maturity date, recover the securities it has transferred to B. The securities will have matured, and in lieu thereof B will pay A what the Treasury owes B as securities-holder – namely, the face value of the securities plus the accrued coupon interest.

In contrast with the open repo, in which A's profit or loss turns on what happens to the market value of the securities and to short-term interest rates while the transaction is pending, the repo-to-maturity dictates *ex ante* the payout at maturity. Indeed, from a profitability perspective A has no occasion to enter into a repo-to-maturity unless the coupon interest A will receive at maturity exceeds the interest it will, at the inception of a repo-to-maturity, have to obligate itself to pay to B at maturity. If coupon interest is equal to or less than the market interest rate prevailing at the time A is considering a repo-to-

maturity, A would normally eschew the repo-to-maturity and either (a) hold the securities until they mature, or (b) sell them outright.

In this case, the government alleges that MBM, the firm of which defendant Wexler was, variously, chief financial officer and managing partner, entered into numerous repo-to-maturity transactions, designed by Wexler, in which MBM agreed to pay out, and in fact did pay out, more in market interest than it received in coupon interest. Moreover, according to the government's allegations, it was part of Wexler's design that his firm purchase the securities and "repo" them simultaneously. The entire purpose of the transaction, so the government contends, was to create interest expenses that could, for tax purposes, be treated as a cost of business to be offset against profits from other transactions.[3]

Key to the effectuation of the scheme as described by the government was that the repo-to-maturity period was constructed to span two tax years. In the hypothetical example proffered by the government to the district court, and renewed in its brief to this court, the three-month repo-to-maturity transaction would run from November 1 in the first tax year, the date on which the securities were purchased and immediately repoed, to February 1 in the second tax year, the date on which the securities were to mature. This calendar arrangement

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[3] The repo interest rate was set at .01% above the 6.0% coupon interest rate, thus yielding the repo lender – the other party to the repo – a quite modest return (which the government characterizes as a "fee". Petition for Writ of Mandamus or Prohibition, at 3) for cooperating in establishing the repo.

would make it possible for the interest owed in November and December to be treated as a deductible expense in the first tax year, while the November-December-January coupon interest – partially offset by the January interest payment – would not need to be reported as income until the second tax year. Although in the aggregate two months of interest deductions in the first tax year would appear to be balanced by two months of interest income in the second tax year, the apparent symmetry is illusory from a revenue standpoint: it would not be until the filing of the return for the second tax year that the government would recoup the taxes not paid in the first tax year, with the result that the government would for a year lose the use of the sum ultimately recouped.[4]

In sum, the government contends that the repo-to-maturity device illustrated above was the centerpiece of a conspiracy in which, according to ¶ 9 of the superseding indictment, Wexler and others undertook, between 1982 and 1986, "to generate more than $740 million ($740,000,000) in fraudulent interest expenses chargeable to MBM", which "fraudulent expenses were in turn used by Wexler and his co-conspirators to create more than $160 million ($160,000,000) in bogus tax deductions for the partners of MBM."

The November 30, 1993 Order: In October, 1993, the government moved for a declaration of various principles of tax law in order to preclude certain defenses that prosecutors anticipated from Wexler. The government's

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[4] Conversely, the taxpayer would, of course, gain the value of having the use of that money for the additional year.

motion contained the following proposed jury instruction:

> I instruct you that, if [the government securities transactions in this case] were sham transactions, then interest and other expenses that MBM incurred as a result of the transactions were not deductible. Whether or not the transactions were shams is a question that is for you to decide. I instruct you, however, that you must find the transactions were sham transactions if you determine two things beyond a reasonable doubt:
>
> *First,* that MBM had no business purpose for entering into the transactions other than to obtain tax benefits; and
>
> *Second,* that there was no reasonable possibility that MBM could earn a profit on the transactions apart from tax benefits.

Defendant also proposed a jury charge to the court, which included the following instruction:

> Assuming the Government has proven that the governmental security trades were sham transactions (i.e. no business purpose *and* devoid of economic substance), you cannot convict the defendant if you find that the interest expenses at issue were the product of a "genuine indebtedness". In other words, regardless of any conclusions you reach as to the motivation of the defendant or the lack of economic substance, the existence of a genuine debt between MBM and its trading partners, will permit the deduction of interest. Under the tax laws, even a sham transaction may have elements that have economic substance, and these elements of the transaction

> must be respected for tax purposes. Accordingly, if you find that the financing agreement to purchase the government securities is genuine and enforceable, the interest may be deducted.

In its November 30, 1993, Order the district court adopted an instruction on sham transactions to be delivered to the jury. The court's instruction adopted both parties' central suggestions, including the "genuine indebtedness" paragraph, above, proposed by defendant. The court's instruction, in relevant part, is as follows:

> I instruct you that, if these transactions in government securities were sham transactions, then interest and other expenses that MBM incurred as a result of the transactions were not deductible, with certain exceptions I will explain in a moment. Whether or not the transactions were economic shams is a question that is for you to decide. I instruct you, however, that you must find the transactions were sham transactions if you determine two things beyond a reasonable doubt:
>
> > *First*, that MBM had no business purpose for entering into the transactions other than to obtain tax benefits; and
> >
> > *Second*, that there was no economic substance to the transaction, that is there was no reasonable possibility that MBM could earn a profit on the transactions apart from tax benefits.
>
> * * *
>
> *Genuine Indebtedness*
>
> Assuming the government has proven that the governmental security trades were sham

transactions (i.e. no business purpose *and* devoid of economic substance), you may convict the defendant on the count you are considering only if you find that the interest expenses at issue were not the product of a "genuine indebtedness." In other words, regardless of any conclusions you reach as to the motivation of the defendant or the lack of economic substance in any transaction as a whole, the existence of a genuine debt between MBM and a trading partner, could permit the deduction of interest under the Internal Revenue Code. Under the tax laws, even an economic sham transaction may give rise to genuine indebtedness and could generate lawful interest deductions.

Genuine indebtedness exists if the parties intended to create and enforce a binding obligation on the part of MBM to pay interest on a loan. In determining whether genuine indebtedness exists in a particular transaction, you must consider the substance of the transaction, as intended by the parties, not only the form that the transaction took. You may consider all relevant evidence bearing on the parties' intent. Among your duties as jurors, you must carefully analyze the evidence applicable to each count to see if one or more obligations generating a genuine indebtedness with actual, deductible interest was or was not present. The government must prove the lack of genuine indebtedness beyond a reasonable doubt.

District Court Order of November 30, 1993.

The government objected to the district court's order, and moved for reargument. The district court denied the motion and similarly denied a stay of trial while the

government petitioned this court for mandamus or prohibition. We subsequently granted to stay pending decision on the petition.

The government seeks the extraordinary relief of mandamus or prohibition (which we will, hereafter, treat simply as a petition for mandamus) because it contends that (1) the district court's announced jury instruction on genuine indebtedness is clear legal error; (2) the government will be unable to proceed to trial in good faith within the rubric of that instruction and will, therefore, have to move to dismiss the indictment; (3) the error is unappealable; and (4) the district court's ruling, if allowed to stand, will affect other cases by virtue of setting an erroneous rule that makes tax cases involving sham transactions far more difficult to prosecute.

Resolution of the petition before us hinges upon two questions: First, is the instruction on genuine indebtedness contained in the district court's November 30, 1993, Order clearly erroneous? Second, if the answer to the first question is "yes", is the error one whose probable consequences meet the strict standard for granting a writ of mandamus?

The proposed instruction

The government's principal argument is that the district court's November 30, 1993, Order adopts an instruction that is patently contrary to the law. Specifically, the government argues that economic sham transactions cannot generate lawful deductions of interest expense, even if they involve the payment of interest on "genuine indebtedness". Gov't Br. at 27.

1) *General rule on sham transactions*: The general rule on sham transactions in this circuit is well-established: "If a transaction is devoid of economic substance . . . it simply is not recognized for federal taxation purposes, for better or for worse. This denial of recognition means that a sham transaction, devoid of economic substance, cannot be the basis for a deductible loss." *Lerman v. Comm'r of Internal Revenue*, 939 F.2d 44, 45 (3rd Cir. 1991), *cert. denied*, 112 S.Ct. 1940 (1992). *Lerman* reflects the fundamental and long-standing rule that taxation depends on the substance, not the form, of transactions. *See e.g. Gregory v. Helvering*, 293 U.S. 465, 469-70 (1935).

Where a transaction has no substance other than to create deductions, the transaction is disregarded for tax purposes. *Knetsch v. United States*, 364 U.S. 361, 366 (1960); *Demartino v. Commissioner*, 862 F.2d 400, 401 (2nd Cir. 1988). Deductions for expenses resulting from such transactions are not permitted. *James v. Commissioner*, 899 F.2d 905, 908 n.4 (10th Cir. 1990) ("transactions lacking an appreciable effect, other than tax reduction, on a taxpayer's beneficial interest will not be recognized for tax purposes"); *Yosha v. Commissioner*, 861 F.2d 494, 499 (7th Cir. 1988) (where transactions "were devices whose only possible or contemplated effect was to avoid taxes, and *a fortiori* they were not engaged in for profit", resulting deductions violate the tax code).

Wexler does not challenge the sham-transaction doctrine in general. Rather, Wexler argues that the doctrine

does not apply to deduction of interest payments pursuant to § 163[5] of the tax code if the taxpayer's obligation to pay the interest is binding and enforceable. Wexler grounds his arguments in both the statute and the case law. First, he argues that § 163 differs from other sections of the code by not requiring that the underlying transaction be motivated by profit. Second, he argues that a modern trend in the case law favor allowing deductibility of genuine debt, even when related to a sham transaction. We address these arguments in order.

2) *Deductibility under § 163*: Section 163(a) of the Internal Revenue Code, 26 U.S.C. § 163(a), states that "[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."[6] Wexler argues that "[i]n contrast to other sections of the Internal Revenue Code allowing for deductions, Section 163 does not require any profit motive or the conduct of a trade or business in order to claim the deduction for interest expense." Respondent's Br. at 20. The apparent thrust of the argument is that, unlike deductions taken pursuant to other sections of the Code, deductions under § 163 are permitted for interest obligations resulting from sham transactions, so long as those obligations are "genuine" – i.e. binding and enforceable.

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[5] 26 U.S.C. § 163, see *infra*.

[6] Although subsequent subsections of § 163 contain various exceptions and qualifications to that rule, it is undisputed that an individual taxpayer is entitled to deduct a proportionate share of interest expense incurred by a business in which the taxpayer is a partner.

It is true, as Wexler argues, that other code sections expressly require that the deductions they provide for arise from transactions having a business purpose or profit motive, whereas § 163 does not.[7] Nonetheless, the case law construing § 163 clearly establishes that the sham transaction doctrine also bars interest deductions under that section of the code. In *Knetsch v. United States*, 364 U.S. 361 (1960), the Supreme Court held that interest deductions under the relevant language of § 163(a) of the 1954 Code (and the identical language of the predecessor provision, § 23(b) of the 1939 Code[8]) are not permissible when the underlying transaction is determined to have been a sham. Knetsch purchased $4,000,000 worth of 30-year, deferred annuity, bonds carrying a 2.5% interest rate. He borrowed the $4,000,000 purchase price at a rate of 3.5%, pledging the bonds as security for the loan. In each of the two years at issue, Kentsch paid the interest on the loan balance, and received a loan in the amount of the increased value of the annuity bonds. The Court

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[7] Among the examples cited by Wexler are the following: Section 165(c) limits deductible losses under § 165(a) "to (1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business. . . . " Under § 167(a), a taxpayer may deduct depreciation "(1) of property used in a trade or business, or (2) of property held for the production of income." Likewise, § 212 allows deductions of expenses "incurred during the taxable year (1) for the production or the collection of income; (2) for the management, conservation or maintenance of property held for the production of income. . . . "

[8] The old § 23(b) is identical to the modern § 163, and was simply renumbered upon enactment of the 1954 Code. *See Knetsch*, 364 U.S. at 362 & n.1. The language is unchanged in § 163 of the 1986 Code.

found that he paid a total of $294,570 in interest, and received $203,000 in loans. Knetsch's net out-of-pocket costs were thus $91,570. Meanwhile, the equity value of the annuity bonds – the amount by which the value of the bonds exceeded Knetsch's debt – was only $1000. The Court found that, apart from tax benefits, the only benefit from Knetsch's $91,570 out-of-pocket expenditure was "the relative pittance" of $1000. *Id.* at 366. The Court concluded that Knetsch's expenditures "did not appreciably affect his beneficial interest except to reduce his tax", and that there was "nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction." *Id.* The court therefore held that the loan transactions were shams and disallowed Knetsch's interest deductions.

Wexler does not undertake to address *Knetsch* in his brief. Yet *Knetsch* plainly contradicts respondent's claim that a sham transaction can give rise to deductions under § 163. So do many other cases. The seminal sham-transaction case of *Goldstein v. Commissioner,* 364 F.2d 734 (2nd Cir. 1966), specifically addressed deduction of interest expenses pursuant to § 163(a). *Id.* at 736. The underlying transaction involved a sweepstakes winner who borrowed money at 4.0% to purchase bonds yielding 1.5%, and then tried to deduct the interest payments on the loan from her taxable winnings. Notwithstanding the lack of an explicit requirement of a profit motive or business purpose in the text of § 163, the Second Circuit ruled the deduction invalid because the interest had arisen from a transaction entered into "without any realistic expectation of profit and 'solely' in order to secure a large interest deduction". *Id.* at 740.

In *Lifschultz v. Commissioner,* 393 F.2d 232 (2nd Cir. 1968), the court disallowed interest deductions under § 163 for five transactions because the transactions were entered into without expectation of economic profit and had no purpose beyond creating tax deductions. The Second Circuit ruled that "the controverted payments did not constitute interest within the meaning of Section 163(a) and were not deductible." *Id.* at 234. Similarly, in *Lukens v. Commissioner,* 945 F.2d 92 (5th Cir. 1991), the Fifth Circuit upheld denial of an interest deduction under § 163 where the trial court had reasonably found that " 'petitioners did not have a profit objective, independent of tax savings' " for engaging in the underlying transaction. *Id.* at 100 (quoting trial court opinion); *See also United States v. Manko,* 979 F.2d 900, 910-11 (2nd Cir. 1992) (approving, in dicta, jury instruction that would bar interest deduction if underlying transaction did not involve profit potential or market risk).

The Ninth Circuit has likewise held that a sham transaction cannot generate genuine indebtedness for § 163 purposes. *Shirar v. Commissioner,* 916 F.2d 1414, 1417 (9th Cir. 1990). The *Shirar* court stated that "ordinarily" § 163 permits interest paid on indebtedness to be deducted, but only if the interest is paid on genuine indebtedness. *Id.* Citing *Knetsch,* the court held that no genuine indebtedness can result from a sham transaction, which it defined as a transaction from which "there is nothing of substance to be realized beyond a tax deduction." *Id.*

The Tax Court has also disallowed § 163 deductions where the underlying transaction constituted an economic sham. In *Sheldon v. Commissioner,* 94 T.C. 738

(1990), the court addressed the question of whether interest obligations from repo transactions very similar to those Wexler allegedly engaged in could be deducted under § 163. The court acknowledged that under § 163 deductibility is not expressly contingent upon a profit objective in the underlying transaction. *Id.* at 760. The court held, however, that interest is nonetheless not deductible when it has resulted from a transaction that lacked economic substance – i.e. had no " 'purpose, substance or utility apart from [its] anticipated tax consequences.' " *Id.* at 761 (quoting *Goldstein*, 364 F.2d at 740).[9]

While there is no case in this court that specifically addresses the deductibility under § 163 of interest payments on sham transactions, we have addressed whether economic shams could create deductible interest payments under § 23(b) of the 1939 Internal Revenue code, the predecessor of § 163. *Weller v. Commissioner*, 270 F.2d 294 (3rd Cir. 1959). The issue in *Weller* – a case decided a year before *Knetsch* – was the deductibility of prepaid interest on annuity contract loans. We found that "although in form the payments appear to constitute

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[9] As the government notes, *Sheldon* actually expanded the sham transaction doctrine, because it barred interest deductions from arrangements motivated by tax benefits even if the transactions could have generated a profit. The dissent argued that repo transactions with profit potential should be recognized for tax purposes. *Id.* at 774-75. The dissent agreed with the majority, however, that repos-to-maturity that assure lack of profit do not give rise to deductible interest. *Id.* Thus, the *Sheldon* court was unanimous that the kind of transactions Wexler is charged with arranging cannot create tax deductions, regardless of whether there was "genuien indebtedness".

interest within the meaning of section 23(b) of the Internal Revenue Code of 1939, the entire transaction lacks substance." *Id.* at 296. We cited *Gregory v. Helvering*, 293 U.S. 465 (1935), for the general principle that no tax benefit could be created by a transaction entered into for no economic benefit other than tax avoidance. *Weller*, 270 F.2d at 296-97. Noting that *Gregory* involved what the Supreme Court termed "an elaborate and devious form of conveyance masquerading as a corporate reorganization," a camouflage the Court declined to recognize for tax purposes because to do so "would be to exalt artifice above reality." 293 U.S. at 470. We said in *Weller* that "the principle laid down in the *Gregory* case is not limited to corporate reorganizations, but rather applies to the federal taxing statutes generally." *Id.* at 297. We rejected the petitioners' argument that the deduction should be allowed because the interest obligation was real: "That there may be an obligation which is binding under local law is not determinative of whether there is a true indebtedness within the meaning of Section 23(b)." *Id.* at 298.

In *Weller*, we held that interest payments are not deductible where the underlying transaction has no purpose other than tax avoidance, despite the fact that § 23(b) – now § 163(a) – had no express business-purpose requirement. We also held in *Weller* that the existence of a real obligation to pay interest – which is how Wexler defines "genuine indebtedness" – does not change the result. *Weller* remains good law. Our recent treatment of the sham transaction doctrine in *Lerman* states that transactions with no economic significance apart from tax benefits lack economic substance. 939 F.2d at 48 & n.6. To be sure, *Lerman* did not involve § 163; but we stated in

Lerman that "economic substance is a *prerequisite* to *any* Code provisions allowing deductions." 939 F.2d at 52 (second emphasis added). We thus find no merit in Wexler's argument that economic substance in the underlying transaction is not required for deductibility under § 163.

3) *Alleged changes in the law:* Wexler argues that recent decisions of the Fourth and Second Circuits and of the Tax Court reflect a modern trend towards a genuine indebtedness exception for § 163 deductions – an exception that the district court was correct to follow. In making this argument, Wexler relies heavily on *Rice's Toyota World v. Commissioner,* 752 F.2d 89 (4th Cir. 1985), a Fourth Circuit opinion also relied on by the district court in fashioning the jury instruction to which the government has taken such strong exception.

Rice's Toyota, an automobile dealership, purchased a used computer from a leasing company by issuing a recourse note and two non-recourse notes to the seller. Rice's Toyota leased the computer back to the leasing company, and then declared tax deductions for depreciation of the computer and for interest paid on the recourse and non-recourse notes. The Fourth Circuit affirmed the Tax Court's finding that Rice's transaction was a sham because "Rice subjectively lacked a business purpose and the transaction objectively lacked economic substance." *Id.* at 95. After finding that in substance Rice had not purchased a computer, but rather had paid a fee in exchange for tax benefits, the court went on to examine whether any part of the overall scheme was economically substantive. *Id.* The court agreed that the capital depreciation and the interest on the non-recourse notes should

not be deductible. *Id.* However, the Fourth Circuit disagreed with the Tax Court's disallowance of the interest paid on the recourse note. The appellate court held that, despite the sham nature of the underlying transaction, Rice's Toyota purchased "something of economic value", and characterized "the 'cash payment' on the recourse note as a 'fee' for purchase of expected tax benefits." *Id.* at 96. The court held that the installment payments on the recourse notes were "genuine obligations" and that the "interest due upon their payment was equally an obligation of economic substance." *Id.* at 96. Wexler argues that *Rice's Toyota* therefore allows deduction of interest so long as it was paid on an enforceable obligation.

We reject *Rice's Toyota* as authority for the instruction adopted by the district court for three reasons.

First, the Fourth Circuit did *not* hold that interest was deductible in the absence of economic substance. Rather, the court expressly based deductibility of the recourse note interest on a finding that the recourse debt *was* "an obligation of economic substance," *Id.* at 96 – a finding which, if warranted, would of course mean that the interest paid on the recourse note was properly deductible.

Second, and more important, we are unable to reconcile the Fourth Circuit's finding that the recourse note was "an obligation of economic substance" with its definition of "economic substance". According to the Fourth Circuit, "economic substance" involves "a reasonable possibility of profit from the transaction . . . apart from tax benefits." *Id.* at 94. The court held, however, that the recourse note transaction had economic substance because Rice's payment on the note was a "purchase of

something of economic value . . . a 'fee' for purchase of expected tax benefits." *Id.* at 96. By the Fourth Circuit's own definition of economic substance, we do not see how the recourse note payment could possess economic substance given that the only purpose or gain was the tax benefit.

Third and finally, even if we were to accept respondent's interpretation of *Rice's Toyota*, Wexler's case is distinguishable from Rice's. The Fourth Circuit unbundled the sale-leaseback transaction and found that one small part of it, the recourse note, was economically substantive. Rice's transaction was unusual because the interest payments on the recourse note were separable from the interest payments and depreciation that would have created the principal tax benefits of the transaction. It appears that the Fourth Circuit did not view the interest expense on the recourse note as being, in itself, the purpose of Rice's transaction. The chief intended benefits of the sale-leaseback arrangement were the much larger deductions for depreciation and interest on the nonrecourse notes. The court disallowed those larger deductions.

Wexler's case differs in a critical respect. There is no debt obligation that can be separated from the underlying repo scheme or that was undertaken for some reason other than the tax benefits of deducting interest on that obligation itself. The obligation that Wexler argues to be an economically substantive "genuine indebtedness", the loan secured by the government securities, is the very obligation that will generate the interest payments constituting the tax benefits of the entire transaction. Thus, if we were to follow *Rice's Toyota*, the transaction would be

examined for a binding debt obligation even if the jury had found that Wexler's transaction was devoid of business purpose or profit potential other than tax avoidance – i.e. that, by the Fourth Circuit's own definition, the transaction was without economic substance. If such an obligation were found – i.e. that the MBM partnership was obligated to pay interest on the loan secured by the government securities – then the interest would be deductible because, under *Rice's Toyota*, it represents a fee paid for economically valuable tax benefits, thereby giving the transaction economic substance. We think such an outcome would undermine the sham transaction doctrine, for it would allow the MBM partnership to reap the entire tax benefit of its sham transaction simply because MBM was contractually obligated to make payments on the loan that was the centerpiece of the whole scheme. Such an outcome would be incompatible with the holdings of *Weller, Knetsch, Gregory, Goldstein,* and *Lerman.* This may explain why, five years after *Rice's Toyota,* the sixteen Tax Court judges deciding *Sheldon v. Commissioner,* 94 T.C. 738 (1990), all agreed that interest payments related to a sham transaction cannot be deducted under § 163.[10]

Respondent argues that several recent decisions have followed *Rice's Toyota* on the genuine indebtedness issue, reflecting a current trend in the law. For example, Wexler cites *Jacobson v. Commissioner,* 915 F.2d 832 (2nd Cir. 1990),

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[10] The Tax Court was well aware of *Rice's Toyota* when it decided *Sheldon,* 94 T.C. 760 (citing *Rice's Toyota* and noting that the Fourth Circuit had allowed deduction of the interest paid on the recourse debt).

as evidence that the Second Circuit has abandoned *Goldstein* and now allows deductions of interest payments notwithstanding an underlying sham transaction. But the *Jacobson* opinion does not support Wexler's argument.

In *Jacobson*, the court stated that "[e]ven if the motive for a transaction is to avoid taxes, interest incurred therein may still be deductible if it relates to economically substantive indebtedness." 915 F.2d at 840 (citing *Rice's Toyota*). The government does not quarrel with that formulation here: indeed, the two-part definition of a sham transaction proposed by the government and adopted by the district court would require the jury, in order to "find the transactions were sham transactions," to "determine two things beyond a reasonable doubt:"

> *First*, that MBM had no business purpose for entering into the transactions other than to obtain tax benefits; and
>
> *Second*, that there was no economic substance to the transaction, that is there was no reasonable possibility that MBM could earn a profit on the transactions apart from tax benefits.

Thus, what *Jacobson* holds is that interest will be deductible where the government proves lack of business purpose, but cannot prove lack of economic substance – i.e. if the underlying transaction is not a "sham" as defined by the district court's order in Wexler's case.[11]

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[11] We find it difficult to believe that, had the Second Circuit intended anything more – i.e. to allow deductions of *any* interest that actually had to be paid – it would have done so without explicitly addressing and overruling its oft-cited *Goldstein* decision. That it had no intention of doing so is evidenced by a

Respondent also relies heavily on the Tax Court's recent decision in *Lieber v. Commissioner*, 66 T.C.M. (CCH) 722 (1993). In *Lieber*, the court addressed, *inter alia*, the deductibility of interest obligations incurred in connection with a computer purchase and lease transaction. The Tax Court first cited its own opinion in *Rose v. Commissioner*, 88 T.C. 386, 423 (1987), *aff'd.* 868 F.2d 851 (6th Cir. 1989), in which it had stated that under § 163 a taxpayer may deduct interest payments even absent a tax-independent motive for the underlying transaction. The Tax Court in *Lieber* went on, however, to acknowledge that its *Rose* dictum was in conflict with its more recent ruling in *Sheldon* that transactions "give rise to deductible interest only if there is some tax-independent purpose for the transactions." *Sheldon*, 94 T.C. at 759.

Contrary to Wexler's argument, the Tax Court in *Lieber* did not reject *Sheldon* in favor of *Rose*, but expressly decided not to resolve the tension between *Rose* and *Sheldon*. Rather, it decided that, because an appeal in *Lieber* would be to the Second Circuit, which in the Tax Court's view had adopted the *Rose* dictum in *Jacobson*[12],

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Second Circuit case decided just six weeks before *Jacobson*, by a panel including two Judges (Newman and Pratt, JJ) of the three judges who decided *Jacobson*, in which the court stated that "[t]hough . . . a 'repo to maturity' repurchase agreement, is legal, it provides no basis for claiming an interest expense deduction since no profit or loss can be realized in connection with the interest charges." *United States v. Oshatz*, 912 F.2d 534, 536 (2nd Cir. 1990).

[12] As our discussion of *Jacobson* suggests, typescript, *supra*, text at p. 23, and n. 11, we are not at all clear that *Jacobson* should be regarded as building in some significant sense on *Rose*.

the Tax Court would follow *Rose* in *Lieber.* Thus, the Tax Court did *not* decide which position was correct, but rather decided the question with reference to what the Tax Court perceived the law to be in the relevant circuit court of appeals. Thus, the only relevance of *Lieber* to the instant case is to indicate that, were the instant case one that had arisen in the Tax Court, that court would have decided the issue at bar with reference to the prevailing law of the this circuit. And in this circuit, under *Weller* and *Lerman,* the interest arising from Wexler's transaction is not deductible if the underlying repo transaction is a sham.

We are convinced that there is no basis for finding that interest payments arising from the repo-to-maturity transactions allegedly arranged by Wexler should be deductible as "genuine indebtedness". *Rice's Toyota, Jacobson* and *Lieber* indicate that, in some circumstances, a sham transaction may have separable, economically substantive, elements that give rise to deductible interest obligations.[13] Yet in each of those cases a key requirement is that the interest obligation be *economically substantive,* defined in every decision except *Rose* to mean that the transaction have a potential non-tax benefit. The jury instruction that the district court adopted in its November 30, 1993, Order goes even further: if, pursuant to the sham transaction instruction, the jury were to find beyond a reasonable doubt *both* "no business purpose . . . other than to obtain tax benefits" *and* "no

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[13] Wexler cites no case in which the very interest comprising the entire tax benefit of a sham transaction has been ruled deductible as "genuine indebtedness".

economic substance [because] there was no reasonable probability [of] a profit . . . apart from tax benefits," deductibility would still follow unless the government proved beyond a reasonable doubt the "lack of genuine indebtedness."[14] We find that this instruction would render the sham transaction doctrine inert, and that the instruction is at odds with the overwhelming weight of the relevant case law.

4) *Clear error in the November 30, 1990, Order:* On the basis of the foregoing discussion, we find that the "genuine indebtedness" instruction adopted by the district court constitutes clear error under established law. This circuit held in *Weller* that interest payments arising from a sham transaction are not deductible. 270 F.2d at 296-98. Our rule of disregarding sham transactions for federal taxation purposes continues in full force today, with no exception for § 163 deductions. *Lerman,* 939 F.2d at 48 & n.6, 52 ("economic substance is a *prerequisite* to *any* Code provisions allowing deductions") (second emphasis added); *see also Peerless Industries v. United States,* 1994 U.S. Dist. LEXIS 411 *17, 94-1 U.S. Tax Cas. (CCH) ¶ 50,043 (E.D.Pa. 1994), (§ 163 "deduction is proper if there is some substance to the loan arrangement beyond . . . the deduction."). The jury instruction adopted by the district court in its November 30, 1993, Order conflicts with the established law of this circuit, and with the dominant line of precedent following the Supreme

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[14] "Genuine indebtedness" being defined by the district court as simply "a binding obligation . . . to pay interest on a loan."

Court's ruling in *Knetsch* and the Second Circuit's ruling in *Goldstein*.

Whether a writ of mandamus should issue

The standard for issuing a writ of mandamus is stringent. As a threshold matter, the petitioner must prove that the district court committed a "clear abuse of discretion", *Mallard v. U.S. District Court*, 490 U.S. 296, 309 (1989), or a "clear error of law", *In Re Bankers Trust Co.*, 775 F.2d 545, 547 (3rd Cir. 1985). We have found that the government has met that burden in this case.

In addition to demonstrating clear error, however, the petitioner must generally show that, other than mandamus, it has no means of adequate relief, *Bankers Trust*, 775 F.2d at 547, and that the error will cause irreparable injury, *Cippolone v. Liggett Group, Inc.*, 785 F.2d 1108, 1118 (3rd Cir. 1986).

We find in this case that the government has no alternative avenue of relief. The government sought rehearing on the intended jury instructions, but rehearing was denied. For double-jeopardy reasons, no appeal will be possible once trial begins. The government will not be able to interrupt the trial by filing an appeal or a renewed petition for mandamus when the district judge commences to give the erroneous instruction. And if – as the government anticipates, and Wexler does not contest – jury deliberations guided by the erroneous instruction end in an acquittal, the injury to the government will be irremediable.[15]

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[15] This would be so even if the district court, without submitting the case to the jury, granted a motion by defendant,

We are mindful of respondent's argument that mandamus is an extraordinary remedy, reserved for rare circumstances. We believe, however, that this case presents an appropriate occasion for exercise of the writ. Not only do we find clear error, likelihood of irreparable harm, and lack of alternatives, but we also note the absence of certain factors that would weigh against mandamus. A principal concern with mandamus is that it not be used as a substitute for appeal. *In Re School Asbestos Litigation*, 977 F.2d 764, 772 (3rd Cir. 1992). Indeed, "[m]andamus is disfavored because its broad use would threaten the policy against piecemeal appeals." *Id.* In the case at bar, issuance of the writ will neither substitute for appeal nor bring this case piecemeal to this court, for the simple reason that appeal from the erroneous instruction is not an option for the government.[16]

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pursuant to Fed. R. Crim. P. 29(a), for acquittal after the close of the government's evidence.

[16] Wexler also argues that issuance of a writ in this case would contravene the Criminals Appeals Act, 18 U.S.C. § 3731, and *Will v. United States*, 389 U.S. 90 (1967), which mandates that "mandamus may never be employed as a substitute for appeal in derogation of the" principle that the "Criminal Appeals Act is strictly construed against the Government's right of appeal." *Id.* at 96-97. *Will*, however, does not preclude the use of mandamus to review an interlocutory order that expresses an erroneous, preliminary jury instruction. In *Will*, the Court states that it would not "say that mandamus may never be used to review procedural orders in criminal cases." *Id.* at 97. Moreover, the Court stated that "it need not decide under what circumstances, if any," a court may review "an interlocutory procedural order . . . which did not have the effect of a dismissal." *Id.* at 98. While it might be difficult to characterize a jury instruction as

Wexler would cabin our discretion to order mandamus to situations in which a district court either exceeded its lawful jurisdiction or declined to exercise a nondiscretionary power. While those two situations constitute traditional reasons for the writ, they are not exclusive. Indeed, we have observed that "courts have not confined themselves to any narrow or technical definition of the term 'jurisdiction' " in using the writ to regulate proceedings in the district court. *United States v. Santtini*, 963 F.2d 585, 594 (3rd Cir. 1992). Accordingly, mandamus may issue to correct clear abuses of discretion, to further "supervisory and instructional goals", and to resolve "unsettled and important" issues. *In Re School Asbestos Litigation*, 977 F.2d at 773. While appellate courts must be parsimonious with the writ, it is also true that "[s]ome flexibility is required if the extraordinary writ is to remain available for extraordinary situations." *Id.*

We find that the adoption of a clearly erroneous jury instruction that entails a high probability of failure of a

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procedural, still under *Will* the mandamus door is open far enough to include jury instructions.

Accordingly, while we do not attempt to set forth the exact parameters of when mandamus is available to address interlocutory orders in criminal cases, we do find that on the facts of this case mandamus is appropriate. Accepting the government's assertion that our failure to exercise mandamus review over the order would hamper the government's ability to enforce the tax laws, we find that this interlocutory order presents a special situation which militates in favor of mandamus review. We must acknowledge, however, that our granting the writ in this context does not authorize the use of mandamus whenever the government objects to criminal jury instructions. Rather, our decision is limited to the facts of this case.

prosecution – a failure the government could not then seek to remedy by appeal or otherwise – constitutes the kind of extraordinary situation in which we are empowered to issue the writ of mandamus. Accordingly, the petition for a writ of mandamus is granted, the district court is directed to vacate its order of November 30, 1993, and the proceedings in the underlying case shall be consistent with this opinion.

GREENBERG, *Circuit Judge*, concurring:

I join in the opinion of the court because I believe that it correctly states the substantive tax law and because I further believe that it is appropriate for us to exercise our mandamus jurisdiction to direct the correction of the error in the proposed charge. Nevertheless I do so with some reluctance because I have difficulty reconciling Wexler's prosecution with the principles underlying *Cheek v. United States*, 111 S. Ct. 604 (1991). In its petition for mandamus the government tells us that "the district court's order adopts an erroneous jury instruction predicated on a fundamentally incorrect reading of the tax law [which] if not corrected by this Court . . . will force the government to dismiss the charges. . . . " Petition at 1. Thus, the government explains, the "incorrect instruction would virtually preclude the government from obtaining a conviction [as] it would leave [it] with no means of proving a critical element of its case – that the interest deductions at issue were invalid." Petition at 2. The government adheres to this position in its reply brief, asserting that the district court's error "will force the government to dismiss the criminal charges." Reply brief at 4. In the circumstances, it is evident that the government's trial problem is that the district court

intends to charge the jury that the deductions involved in this case were not unlawful, and the government quite understandably feels that in the face of that charge it cannot be successful at trial.

What bothers me in the government's position is that it is challenging a conclusion reached by the district court in a carefully crafted formal, though unpublished opinion, rendered after the court considered the appropriate authorities, including some of the very cases we cite, *e.g.*, *Lerman v. Comm'r*, 939 F.2d 44 (3d Cir. 1991), *cert. denied*, 112 S. Ct. 1940 (1992). Furthermore, the district court adhered to its conclusion on reconsideration. Therefore, Wexler is being prosecuted in a case in which the government intends to demonstrate that he acted in what the district court believed was a lawful manner. This circumstance almost has caused me to vote to deny the government's petition.

In *Cheek* the Supreme Court noted that "[t]he proliferation of statutes and regulations has sometimes made it difficult for the average citizen to know and comprehend the extent of the duties and obligations imposed by the tax laws." 111 S. Ct. at 609. Thus, "[i]n the end [in a criminal case] the issue is whether, based on all the evidence, the Government has proved that the defendant was aware of the duty at issue, which cannot be true if the jury credits a good-faith misunderstanding and belief submission, whether or not the claimed belief or misunderstanding is objectively reasonable." *Id.* at 611. The Supreme Court's formulation throws into question the fairness of Wexler's prosecution for even the district court did not believe that Wexler violated "the duty at issue." Thus, I have considered whether, notwithstanding the government's demonstration of a *prima facie* case for

the issuance of a writ of mandamus, we should not exercise our discretion by denying its application. *See In re School Asbestos Litig.*, 977 F.2d 764, 772 (3d Cir. 1992).

However, I ultimately do join in the opinion for I do not question the government's good faith in *instituting* the criminal case as I have no doubt that it was surprised by the legal conclusions reached by the district court, and, on the limited record before us, I do not know all the circumstances which led the government to seek Wexler's indictment. Furthermore, I cannot possibly fault the government for seeking a writ of mandamus from this court as I accept its representation that, unless corrected, the district court's unreported opinion will be circulated and will stand as an impediment to the enforcement of the tax laws. Of course, now that the government has obtained its goal of overcoming the district court's opinion, the determination whether this *criminal* case should be *continued* must be made by the prosecuting authorities and not by this court.

I close, however, by pointing out that our opinion is narrow. We only give directions with respect to the charge to the jury. Accordingly, we do not address the possibility that Wexler may in some way be able to bring to the jury's attention the district court's opinion to support a contention that he acted in good faith with respect to the transactions and the deductions involved. That issue, however, is not before us and consequently I express no opinion with respect to it.

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Clerk of the United States Court of Appeals
for the Third Circuit

NOT FOR PUBLICATION

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

UNITED STATES OF AMERICA	:	Criminal No.
	:	92-181
v.	:	
	:	**OPINION**
VICTOR WEXLER	:	

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BISSELL, *District Judge*

This motion arises from a superseding Indictment filed against defendant for conspiring to defraud the United States Internal Revenue Service by submitting on his own behalf and on behalf of others income tax forms claiming interest expense deductions for transactions which do not yield true interest expense deductions. The government has moved this Court to preclude defendant form raising certain defenses at his trial for income tax

fraud and income tax evasion. Suggested jury instructions at the opening of trial have been presented in both the supporting and opposing papers. In adjudicating the present motion, the Court will resolve the form and substance of such instructions. Copies thereof are attached hereto.

FACTS

The superseding Indictment charges that defendant Wexler created more than $160 million in fraudulent tax deductions for the partners of his firm McMahan, Brafman, Morgan & Co. ("MBM") by causing MBM to participate in securities transactions which generated large, ostensibly deductible interest expenses on paper, but which were in fact secretly prearranged to ensure that MBM would neither earn profit nor bear risk of incurring actual expenses or trading losses. The government alleges that these transactions created deductions which led to fraudulent tax savings in the hundreds of millions of dollars.

The Indictment alleges that these transactions violated the tax laws and charges that, by engaging in the transactions, defendant conspired to defraud the Internal Revenue Service, in violation of 18 U.S.C. § 371 (1988) (Count 1) and aided in the preparation and filing of false tax returns which claimed unallowable deductions in violation of 26 U.S.C. § 7206(2) (1988) (Counts 2-8). Defendant seeks to challenge the government's interpretation of the law governing the legitimacy of the transactions at issue by arguing that, even if the securities transactions were prearranged to gain tax benefits, the MBM partners

were nevertheless entitled to deduct the interest expenses listed on the firm's books. (Government's Br. at 2). The government concedes that, if such an argument were valid, it could constitute virtually a complete defense to many of the charges against defendant. Accordingly, it seeks to have defendant barred from presenting the argument to the jury, contending that it is invalid as a matter of tax law.

The motion requires this Court to consider proposed jury instructions regarding whether the transactions in question were economic shams without effect for tax purposes, whether the interest expenses in question were properly deductible as genuine, legally-unenforceable indebtedness, and whether the defense is entitled to a preliminary charge that the jury, in order to deliver a conviction, must find that the defendant acted in bad faith.

SUMMARY

Defendant is indeed subject to criminal prosecution for reporting interest expense deductions on transactions which were prearranged to avoid any market risk. *See United States v. Atkins*, 869 F.2d 135 (2d Cir.), *cert. denied*, 493 U.S. 818 (1989). If defendant committed these acts, he is subject to prosecution for conspiring to violate 26 U.S.C. §§ 7206(1) and (2) and for substantive violations of those statutes.[1]

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[1] Title 18 U.S.C. § 371 (1988) makes it illegal for two or more persons to conspire to commit an offense against the United States or to conspire to defraud the United States or any agency thereof.

Title 26 U.S.C. § 7206(1) (1988) prohibits the willful making and subscribing of false individual and partnership tax returns, and 26 U.S.C. § 7206(2) (1988) prohibits aiding and assisting in the filing of false individual and partnership tax returns.

If a jury finds that defendant deducted interest expenses on transactions that were prearranged "economic shams," it may still find that the deductions were allowable to the extent they were for "genuine indebtedness." A jury may find genuine indebtedness if it finds that defendant had a genuine obligation to pay interest on loans, even if those loans were incurred in order to enable defendant to participate in sham transactions.

Finally, even if a jury finds that the defendant took deductions for sham transactions for which he incurred no genuine indebtedness, the jury may not find defendant criminally liable unless it finds that he acted in bad faith.

For these reasons, defendant is entitled to jury instructions regarding the subject of genuine indebtedness and good faith in addition to instructions defining economic sham transactions.

ANALYSIS

I. "Repo to Maturity" Transactions

The transactions involved in this action are "repossession-to-maturity" transactions, also known as "repo to maturity" agreements. In contrast to a "repo to maturity" agreement, where interest rates on the loan are fixed in advance, a term or "open" repo agreement is one in which a security is purchased with borrowed monies in the hope that the interest earned on the security will exceed the interest due on the loan, which fluctuates with the market. The security itself serves as collateral for the

loan. *See United States v. Oshatz*, 912 F.2d 534, 536 (2d Cir. 1990), *cert. denied*, ___ U.S. ___, 111 S. Ct. 1695 (1991).

In open repossession agreements, "the interest charge on the loan fluctuates with the prevailing market rate, entitling the investor to an interest expense deduction since a profit or loss may be realized on the transaction." (*Id.*) Other tax benefits may flow from the fact that the interest on the loan may be deducted immediately, while the income realized on the underlying security is often not realized until the following tax year. (*Id.*)

If a firm purchased a note with loaned funds, it would presumably hope to realize a gain equal to the difference between the face value of the security at maturity, plus interest earned, minus the principal and interest due on the loan. If the interest earned on the security to be repossessed ("the repo interest") exceeded the rate of the loan interest, the firm would likely realize such a gain. If the repo interest was less than the loan interest, the firm would sustain a loss, assuming that the loan principal and the face value of the security were the same. (Government's Br. at 7-8).

Deductions of interest expenses sustained as a result of open repo transactions are legal because they stem from transactions subject to market risk. *Oshatz*, 912 F.2d at 536. However, under certain circumstances interest deductions could not be taken on repo to maturity transactions because these transactions eliminate the possibility of profit or loss due to market rate fluctuations. Elimination of market risk is accomplished by setting in advance a fixed loan interest rate that coincides with the interest rate on the collateral. *United States v. Atkins*, 869

F.2d 135, 138 (2d Cir.), *cert. denied*, 493 U.S. 818 (1989). (Government's Br. t 12). "Though this type of arrangement . . . is legal, it provides no basis for claiming an interest expense deduction since no profit or loss can be realized in connection with the interest charges." *Oshatz*, 912 F.2d at 536. Furthermore, it is criminal fraud to document these transactions as open repo transactions. (*Id.*, citing *United States v. Atkins*, 869 F.2d 135 (2d Cir.), *cert. denied*, 493 U.S. 818 (1989)).

II. Criminal Liability for Fraudulent Deductions and the Bad Faith Requirement

A person is subject to criminal prosecution for tax fraud for taking in bad faith a deduction which was not allowable. *See, e.g., United States v. Regan*, 937 F.2d 823 (2d Cir. 1991); *United States v. Atkins*, 869 F.2d 135 (2d Cir.), *cert. denied*, 493 U.S. 818 (1989). If defendant committed these acts, he is subject to prosecution for conspiring to violate 26 U.S.C. §§ 7206(1) and (2) and for substantive violations of those statutes.[2] While the question of whether deductions were allowable involves an inquiry into the economic substance of the transactions, as will be discussed below, it is important to note that the question of criminal liability seems to hinge on the presence of

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[2] Title 18 U.S.C. § 371 makes it illegal for two or more persons to conspire to commit an offense against the United States or to conspire to defraud the United States or any agency thereof.

Title 26 U.S.C. § 7206(1) prohibits the willful making and subscribing of false individual and partnership tax returns, and 26 U.S.C. § 7206(2) prohibits aiding and assisting in the filing of false individual and partnership tax returns.

subjective bad faith. The *Regan* court stated that criminal liability was a question not of economic substance, but a question of good faith. If there was a good faith belief that the section of the tax code authorized taking the tax loss, there can be no criminal liability. 937 F.2d at 826.

Where there is a specific good faith defense available to a defendant, general instructions on specific intent are not sufficient. "The district court should [] instruct [] the jury that, if it f[inds] reliance [is] held in good faith, the defendants c[an]not be held criminally liable for proceeding in accordance with that reliance." *Regan*, 937 F.2d at 826 (citing *United States v. Durham*, 825 F.2d 716, 719 (2d Cir. 1987); *United States v. Pedroza*, 750 F.2d 187, 204-05 (2d Cir. 1984), *cert. denied*, 479 U.S. 842 (1986); *United States v. Alfonso-Perez*, 535 F.2d 1362, 1365 (2d Cir. 1976)).

The question of the defendant's subjective good faith is central to criminal liability for tax fraud because the tax laws are considered beyond the ken of the ordinary citizen. In *Regan*, the Second Circuit noted Justice White's observation in *Cheek v. United States*, 498 U.S. 192, ___ U.S. ___, 111 S. Ct. 604, 611 (1991), that "because of the proliferation of tax statutes and regulations, the common law presumption that every person knows the law does not apply where violations of federal criminal tax laws are alleged. Instead, proof of guilt in such cases must be predicated upon a " 'voluntary, intentional violation of a known legal duty.' " *Regan*, 937 F.2d at 827 (citing *Cheek v. United States*, 498 U.S. 912, ___ U.S. ___, 111 S. Ct. at 610 (quoting *United States v. Bishop*, 412 U.S. 346, 360 (1973)).

It seems clear then, that defendant is entitled to offer a defense of good faith, despite the government's contention that defendant may be convicted if the transactions are shown to be economic shams, regardless of defendant's good faith or lack thereof.

III. Economic Sham Transactions

The Court now addresses the question of what instructions should be given to the jury for it to determine whether the deductions at issue were allowable. This inquiry has two steps. First, the jury must determine whether or not the transactions at issue were "economic shams." Next, the jury must decide whether, or to what extent, portions of the transactions resulted in any "genuine indebtedness," which is an allowable deduction.

A transaction is an economic sham if it was arranged for the sole purpose of obtaining a tax benefit and has no economic substance, that is no "market risk" or "reasonable possibility of profit" on the transaction exists. *United States v. Manko*, 979 F.2d 900, 911 (2d Cir. 1992); *United States v. Atkins*, 869 F.2d at 140. *See also Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). The government contends that a transaction is an economic sham if it was entered into for no business purpose other than to obtain tax benefits and the transaction had no economic substance. (Government's Br. at 21-22). "A transaction lacks economic substance if, as of the time it was entered into, there was no reasonable possibility it would produce a non-tax profit." (*Id.* at 22). The defendant urges that the jury must be instructed to view the question of economic substance more broadly in accordance with the Second

Circuit's directive in *United States v. Regan*, 937 F.2d 823, 828 (2d Cir. 1991), *cert. denied*, ___ U.S. ___, 112 S. Ct. 2273 (1992). In that case, defendant argues, the Second Circuit rejected the district court's definition of market risk that precluded the possibility that a prearranged, riskless trade could affect the economic interests of the parties in favor of an approach that examined the transactions to see if they would have any effect on the position of the parties. (Defendant's Br. at 5-6).

In *Lerman v. CIR*, 939 F.2d 44 (3d Cir. 1991), *cert. denied*, ___ U.S. ___, 112 S. Ct. 1940 (1992), the Third Circuit discussed the scope of the jury's inquiry into the economic substance of a transaction and took a position that is more in line with the government's view of how one defines economic substance than is defendant's position. The *Lerman* case was a civil action filed to obtain a declaratory judgment regarding the IRS' disallowance of deductions taken by brokers. The case involved the interpretation of Section 108 of the Deficit Reduction Act of 1984. The court found that Section 108 was intended to encourage courts to look beyond a single transaction to determine if a dealer had a profit motive, since dealers engaged in so many trades that looking at any one in isolation could be misleading. (*Id.* at 53). However, the court stated emphatically that this exception, which is limited to cases dealing with securities brokers engaged in a particular type of transaction called a "straddle transaction," does not change the general rule that transactions must have economic substance, that is, effects other than expected tax benefits, to be qualified for deduction status. (*Id.* at 53-55). The court noted that each

transaction which was entered into primarily for economic benefit and which intentionally avoids making any profit must be considered an economic sham. (*Id.* at 45-48, 52).

The *Lerman* court looked to a transaction in isolation, rather than as part of the numerous continuous dealings of the brokers in question. (*Id.* at 44). Therefore, in keeping with the Third Circuit's opinion in *Lerman*, this Court rejects defendant's contention that the jury should be instructed to consider the transactions in question as part of a large number of transactions involved in running a business and determine whether the overall course of business was affected favorably by the transactions. The Court rejects for the same reason defendant's contention that even transactions which are not intended to earn a profit may have a legitimate business purpose which justifies deducting related expenses. Instead, this Court finds that the jury should be instructed to find that the transactions in question were economic shams if:

> (1) as a subjective matter, defendant had no business purpose for entering into the transactions other than to obtain tax benefits; and
>
> (2) as an objective matter, the transactions lacked economic substance; they were prearranged to eliminate any possibility of making a profit.

See Lerman, 939 F.2d 44, 48-49 n. 6 (citing *Glass v. Commissioner*, 87 T.C. 1087 (Tax Court 1986)).

IV. Genuine Indebtedness

Generally, transactions which are shams do not yield legitimate deductions. The government urges that an economic sham can never be the basis for a legal deduction. However, this Court agrees with defendant's contention that portions of an economic sham which result in "genuine indebtedness" may be deductible, and therefore this Court holds that the jury must be instructed as to what constitutes "genuine indebtedness" in addition to being instructed regarding the elements of an economic sham.

Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (Tax Court 1981), and its progeny recognized that "sham transactions may contain elements whose form reflects economic substance and whose normal tax consequences may not, therefore, be disregarded." *Rice's Toyota World, Inc. v. CIR,* 752 F.2d 89, 96 (4th Cir. 1985) (citing *Grodt,* 77 T.C. at 1243). In *Rice's Toyota v. CIR,* the Fourth Circuit found that a taxpayer was not entitled to deduct as depreciation expense the cost of a recourse note and a nonrecourse note used to "purchase" a computer in a prearranged sale and leaseback transaction which was intended to generate tax-deductible losses. The court reasoned that, since what the taxpayer purchased was not a computer but rather a tax deduction, the taxpayer was not entitled to a depreciation deduction. Nevertheless, the court did find that the taxpayer was entitled to deduct the installment interest expenses that it owed on the recourse note, because the interest actually payable on a genuine debt is deductible. Other courts have cited *Rice's Toyota* for the proposition that genuine indebtedness is deductible, even in nonrecourse loan situations, if the fair market value of the collateral at the time of the

purchase is close enough to the amount of the loan that the borrower would rather pay the loan than lose the collateral. *See Lebowitz v. Commissioner,* 917 F.2d 1314, 1316-18 (2d Cir. 1990). Indeed, *Rice's Toyota* has recently been cited with approval regarding its "genuine indebtedness" ruling. *Jacobsen v. Commissioner,* 915 F.2d 832, 840 (2d Cir. 1990); *Lieber v. Commissioner,* 66 T.C.M. 722, 728-29 (1993). *Lerman* also cites *Rice's Toyota* with approval in defining "economic sham." 939 F.2d at 49.

The government urges this Court to reject *Rice's Toyota,* contending that it is wrongly-decided and poorly reasoned. Because of the case law which supports the proposition that items of genuine indebtedness generate proper deductions even where that debt was incurred in the course of an economic sham transaction, this Court declines to follow the government's position.

CONCLUSION

The government's motion *in limine* is granted in part and denied in part. The jury will be given a preliminary instruction that it cannot convict defendant of a criminal offense unless it finds that he took interest expense deductions improperly and did so in bad faith. In reviewing the transactions to determine whether they had economic substance, the jury should examine each transaction individually, rather than examining the defendant's or MBM's entire business as a whole, and should determine whether there was a reasonable expectation that the transaction under review would yield a profit. To determine that defendant acted improperly in taking an interest expense deduction, the jury must find that the

transaction was an economic sham and that the deducted interest expense under scrutiny was not the product of a genuine indebtedness. The jury instructions to be delivered at the outset of the trial on the subjects of sham transaction, business purpose, economic substance, genuine indebtedness and good faith are annexed hereto as Exhibit A.

/s/ John W. Bissell
JOHN W. BISSELL
United States District Judge

DATED: November 1, 1993

SHAM TRANSACTIONS
(JWB Revision 11/1/93)

The Indictment in this case charges the defendant Victor Wexler: (i) with engaging in a conspiracy to defraud the United States and the Internal Revenue Service ("IRS"), and to cause false statements to be made to the IRS, in connection with income tax returns; and (ii) with actually causing false statements to be made on tax returns filed with the IRS. Of course, the Indictment is only an allegation, not evidence, and is in no way to be considered as evidence by you.

You should be aware, as you listen to the evidence, that under our laws, every taxpayer has the right to deduct every item the law permits, and to minimize his taxes. However, the law condemns the willful and intentional inclusion of items that seek to evade illegally taxes that are justly due to the government.

Here, the Indictment charges that defendant Victor Wexler and others agreed to create, and did create, fraudulent deductions for the partners of a firm known as McMahan, Brafman, Morgan & Co. (or "MBM"). Specifically, the government alleges that the defendant Wexler and others created such fraudulent deductions by causing MBM to enter into sham government securities transactions. The transactions were shams, the government alleges, because their sole purpose was to generate tax deductions and it was known and arranged in advance that, apart from tax benefits, the transactions would not produce any profit for MBM.

I instruct you that, if these transactions in government securities were sham transactions, then interest and other expenses that MBM incurred as a result of the transactions were not deductible, with certain exceptions that I will explain in a moment. Whether or not the transactions were economic shams is a question that is for you to decide. I instruct you, however, that you must find the transactions were such sham transactions if you determine two things beyond a reasonable doubt:

> *First*, that MBM had no business purpose for entering into the transactions other than to obtain tax benefits; and
>
> *Second*, that there was no economic substance to the transaction, that is there was no reasonable possibility that MBM could earn a profit on the transactions apart from tax benefits.

"Business Purpose"

The law permits any taxpayer to have a dual motivation, tax avoidance and non-tax profit. If you find that the transactions were motivated, at least in part, by a "business purpose," to make or preserve a profit or to limit a loss, then the transactions are legitimate and the deductions may be recognized.

"Economic Substance"

In addition to the absence of a legitimate business purpose, the government must prove that the transaction lacked economic substance. In this case, the government has charged that the defendant planned and executed "prearranged, riskless transactions" in governmental securities in order to create tax deductions in the form of interest expenses, for the benefit of the partners of MBM. (Paragraphs 8-11, Indictment).

In order to prove that the transactions lacked economic substance, the government must prove that the transactions were not subject to market risk, i.e., that changes in the market could not have had any effect on the transaction. In this regard, the government must prove that the transaction would have been completed as planned regardless of any movement in the market and that market movements could not have affected the economic interests of any of the parties to the transaction.

Genuine Indebtedness
(JWB Revision 11/1/93)

Assuming the government has proven that the government security trades were sham transactions (i.e. no

business purpose *and* devoid of economic substance), you may convict the defendant on the count you are considering only if you find that the interest expenses at issue were not the product of a "genuine indebtedness." In other words, regardless of any conclusions you reach as to the motivation of the defendant or the lack of economic substance in any transaction as a whole, the existence of a genuine debt between MBM and a trading partner, could permit the deduction of interest under the Internal Revenue Code. Under the tax laws, even an economic sham transaction may have some items or events that have economic substance, and those parts of the transaction could generate lawful interest deductions. Among your duties as jurors, you must carefully analyze the evidence applicable to each count to see if one or more obligations generating a genuine indebtedness with actual, deductible interest was or was not present.

"Good Faith"
(JWB Revision 11/1/93)

It is important that you consider my instructions regarding sham transactions in their proper context. Federal taxation is among the most esoteric, complex and intricate areas of the law. It is rare that a simple and direct statement of tax law may be made without caveats or exceptions. Due to the increasing scope and complexity of the tax laws and regulations, a defendant in a criminal tax case is not presumed to know the law. Instead, the government must prove, as you will be more fully instructed at the conclusion of the case, that Mr. Wexler voluntarily and intentionally violated a known legal duty.

You may not convict the defendant, if you find that he held a good faith belief that the transactions gave rise to legitimate tax deductions as reflected on the tax returns charged. In this regard, it does not matter that the defendant's understanding of the law was erroneous, so long as his understanding was reached in good faith. In determining his good faith you may consider any legal advice or tax counsel be received, and whether or not he relied on such advice, together with all other evidence which you determine could establish the presence or absence of good faith. As with all other elements of the offenses charged in this case, the government must prove beyond a reasonable doubt that Mr. Wexler did not act in good faith regarding the charge you are considering.

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

UNITED STATES OF AMERICA	:	Criminal No.
	:	92-181
v.	:	
	:	**ORDER**
VICTOR WEXLER	:	

This matter having come before the Court pursuant to the motion of the United States "for an order precluding defendant Victor Wexler from presenting" certain defenses or propositions of law in this matter; and said motion having appropriately focused upon certain rules of law to be embodied in instructions to the jury at the

outset of the trial; and the Court having read and considered the papers submitted in support of and in opposition to said motion; and the Court having heard and considered the arguments of counsel; and good cause having been shown for the entry of the within Order, as reflected in this Court's Opinion of even date herewith,

It is on this 1st day of November, 1993,

ORDERED that the motion of the United States is granted in part and denied in part, and that instructions will be delivered to the jury at the outset of the trial in the form annexed to said Opinion as Exhibit A.

/s/ John W. Bissell
JOHN W. BISSELL
United States District Judge

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

UNITED STATES OF AMERICA	:	Criminal No. 92-181
v.	:	**ORDER**
VICTOR WEXLER	:	

This matter having come before the Court pursuant to the motion of the United States for reargument and reconsideration of this Court's Opinion and order of November 1, 1993; and said motion having sought, *inter alia*, a declaration that the prior Opinion and Order was in substance a dismissal of some or all counts of the superseding indictment; and the Court having read and considered the papers submitted in support of and in opposition to said motion; and the Court having heard and considered the arguments of counsel; and good cause having been shown for the entry of the within Order, as reflected by the Court's determinations rendered in open court on November 4 and November 5, 1993,

It is on this 5th day of November, 1993, **ORDERED** that:

1. The motion of the United States for reargument and reconsideration of the Opinion and Order of November 1, 1993 be and the same hereby is in all respects denied;

2. This Court declares that the aforesaid Opinion and Order are not in substance a dismissal of any count of the superseding indictment;

3. The application of the United States for a stay of the present proceedings in this court, in order that the United States may pursue to conclusion an application for a writ of mandamus pursuant to Fed. R. App. P. 21 be and the same hereby is denied;

4. Trial of this matter is rescheduled from November 9, 1993 to November 29, 1993. The period from November 9, 1993 to November 29, 1993 shall be excluded in computing time under the Speedy Trial Act of 1974, for the following reasons:

The ends of justice served by granting this brief adjournment of the trial outweigh the best interest of the public and the defendant in a speedy trial. 18 U.S.C. § 1361(h)(8)(A). More particularly, the United States has represented that it will apply promptly in the United States Court of Appeals for the Third Circuit for a writ of mandamus challenging this Court's Opinion and Order of November 1, 1993. The disposition of that application will materially affect future proceedings in this action. This adjournment will afford to the United States the opportunity to submit such an application to the Third Circuit, and to that Court an opportunity to determine whether that application will be entertained or denied at its outset. Fed. R. App. P. 21(b). The orderly administration of this case and of the Court's calendar, given the anticipated length of this trial, and the brevity of the adjournment granted here support the granting of that adjournment and its exclusion from time calculations under the Speedy Trial Act.

/s/ John W. Bissell
JOHN W. BISSELL
United States District Judge

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

UNITED STATES OF AMERICA	:	Criminal No. 92-181
v.	:	**ORDER**
VICTOR WEXLER	:	(Filed Nov. 30, 1993)

This matter having been opened to the Court on the application of Michael Chertoff, United States Attorney for the District of New Jersey (Paul A. Weissman and J. David Reich, Jr., Assistant U.S. Attorneys, appearing), for an Order clarifying a certain portion of the preliminary jury instructions adopted by the Court's November 1, 1993 Order in this matter, to wit, the first three sentences of the Court's instruction under the heading "Genuine Indebtedness;" and the Court having determined that a potential ambiguity exists in the language of that portion of the instructions in that the term "economic substance" in the third sentence might be read to imply that economic substance is a necessary component of genuine indebtedness, contrary to what is stated in the first two sentences; and the Court not having intended that implication, but having rather intended to declare in its instructions that the existence of a genuine debt between McMahan, Brafman, Morgan & Co. and a trading partner could permit the deduction of interest under the Internal Revenue Code whether or not that debt or any transaction of which it is a part has economic substance; and the Court having further determined that the term "genuine indebtedness" should be further defined as reflected in

the attachments to this Order; and for the better guidance of the parties and the jury, and for good cause shown;

It is on this 29th day of November, 1993, **ORDERED** that:

(1.) The third sentence of the jury instruction on "Genuine Indebtedness" adopted in this Court's Order of November 1, 1993 be revised to read as follows: "Under the tax laws, even an economic sham transaction may give rise to genuine indebtedness and could generate lawful interest deductions."

(2.) The preliminary instruction on genuine indebtedness is expanded to read in the form annexed hereto.

(3.) The preliminary instructions to the jury on the issues of "sham transaction," "genuine indebtednes" and "good faith" shall be delivered in the form annexed hereto.

(4.) The government's application for a stay of this matter, pending its submission of a petition to the United States Court of Appeals for the Third Circuit for a writ of mandamus directed to this Court be, and the same hereby is, denied.

(5.) The trial date in this matter is adjourned to December 6, 1993 to permit the government, in the interim, to file and serve its mandamus petition and to seek a stay of these proceedings from the Court of Appeals.

/s/ John W. Bissell
JOHN W. BISSELL
United States District Judge

SHAM TRANSACTIONS

The Indictment in this case charges the defendant Victor Wexler: (i) with engaging in a conspiracy to defraud the United States and the Internal Revenue Service ("IRS"), and to cause false statements to be made to the IRS, in connection with income tax returns; and (ii) with actually causing false statements to be made on tax returns filed with the IRS. Of course, the Indictment is only an allegation, not evidence, and is in no way to be considered as evidence by you.

You should be aware, as you listen to the evidence, that under our laws, every taxpayer has the right to deduct every item the law permits, and to minimize his taxes. However, the law condemns the willful and intentional inclusion of items that seek to evade illegally taxes that are justly due to the government.

Here, the Indictment charges that defendant Victor Wexler and others agreed to create, and did create, fraudulent deductions for the partners of a firm known as McMahan, Brafman, Morgan & Co. (or "MBM"). Specifically, the government alleges that the defendant Wexler and others created such fraudulent deductions by causing MBM to enter into sham government securities transactions. The transactions were shams, the government alleges, because their sole purpose was to generate tax deductions and it was known and arranged in advance that, apart from tax benefits, the transactions would not produce any profit for MBM.

I instruct you that, if these transactions in government securities were sham transactions, then interest and other expenses that MBM incurred as a result of the

transactions were not deductible, with certain exceptions that I will explain in a moment. Whether or not the transactions were economic shams is a question that is for you to decide. I instruct you, however, that you must find the transactions were such sham transactions if you determine two things beyond a reasonable doubt:

> *First*, that MBM had no business purpose for entering into the transactions other than to obtain tax benefits; and
>
> *Second*, that there was no economic substance to the transaction, that is there was no reasonable possibility that MBM could earn a profit on the transactions apart from tax benefits.

"Business Purpose"

The law permits any taxpayer to have a dual motivation, tax avoidance and non-tax profit. If you find that the transactions were motivated, at least in part, by a "business purpose," to make or preserve a profit or to limit a loss, then the transactions are legitimate and the deductions may be recognized.

"Economic Substance"

In addition to the absence of a legitimate business purpose, the government must prove that the transaction lacked economic substance. In this case, the government has charged that the defendant planned and executed "prearranged, riskless transactions" in governmental securities in order to create tax deductions in the form of interest expenses, for the benefit of the partners of MBM. (Paragraphs 8-11, Indictment).

In order to prove that the transactions lacked economic substance, the government must prove that the transactions were not subject to market risk, i.e., that changes in the market could not have had any effect on the transaction.

Genuine Indebtedness

Assuming the government has proven that the governmental security trades were sham transactions (i.e. no business purpose *and* devoid of economic substance), you may convict the defendant on the count you are considering only if you find that the interest expenses at issue were not the product of a "genuine indebtedness." In other words, regardless of any conclusions you reach as to the motivation of the defendant or the lack of economic substance in any transaction as a whole, the existence of a genuine debt between MBM and a trading partner, could permit the deduction of interest under the Internal Revenue Code. Under the tax laws, even an economic sham transaction may give rise to genuine indebtedness and could generate lawful interest deductions.

"Genuine indebtedness" exists if the parties intended to create and enforce a binding obligation on the part of MBM to pay interest on a loan. In determining whether genuine indebtedness exists in a particular transaction, you must consider the substance of the transaction, as intended by the parties, not only the form that the transaction took. You may consider all relevant evidence bearing on the parties' intent. Among your duties as jurors, you must carefully analyze the evidence applicable to each count to see if one or more obligations generating a

genuine indebtedness with actual, deductible interest was or was not present. The government must prove the lack of genuine indebtedness beyond a reasonable doubt.

"Good Faith"

It is important that you consider my instructions regarding sham transactions in their proper context. Federal taxation is among the most esoteric, complex and intricate areas of the law. It is rare that a simple and direct statement of tax law may be made without caveats or exceptions. Due to the increasing scope and complexity of the tax laws and regulations, a defendant in a criminal tax case is not presumed to know the law. Instead, the government must prove, as you will be more fully instructed at the conclusion of the case, that Mr. Wexler voluntarily and intentionally violated a known legal duty.

You may not convict the defendant, if you find that he held a good faith belief that the transactions gave rise to legitimate tax deductions as reflected on the tax returns charged. In this regard, it does not matter that the defendant's understanding of the law was erroneous, so long as his understanding was reached in good faith. In determining his good faith you may consider any legal advice or tax counsel he received, and whether or not he relied on such advice, together with all other evidence which you determine could establish the presence or absence of good faith. As with all other elements of the offenses charged in this case, the government must prove beyond a reasonable doubt that Mr. Wexler did not act in good faith regarding the charge you are considering.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 93-5719

UNITED STATES OF AMERICA

Petitioner

v.

VICTOR WEXLER,

Respondent

HONORABLE JOHN W. BISSELL

Nominal Respondent

On Petition for a Writ of Mandamus or Prohibition to the United States District Court for the District of New Jersey
(Related to D.C. No. 91-00181)

SUR PETITION FOR REHEARING

BEFORE: SLOVITER, *Chief Judge*, and BECKER, STAPLETON, MANSMANN, GREENBERG, HUTCHINSON, SCIRICA, COWEN, NYGAARD, ALITO, ROTH, LEWIS, and MCKEE, *Circuit Judges*, and POLLAK, *District Judge**

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*Honorable Louis H. Pollak, Senior United States District Judge for the Eastern District of Pennsylvania, sitting by designation.

The petition for rehearing filed by respondent Victor Wexler in the above captioned matter having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the court in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

BY THE COURT:

/s/ Morton I. Greenberg
Circuit Judge

DATED: AUG 12 1994